The opinion in support of the decision being entered today was not written for publication and is not binding precedent of the Board.

UNITED STATES PATENT AND TRADEMARK OFFICE

BEFORE THE BOARD OF PATENT APPEALS AND INTERFERENCES

Ex parte STUART SERKIN, JOHN MALITZIS, RICHARD G. KETCHUM, and PETER MARYTN

MAILED

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U.S. PATENT AND TRADEMARK OFFICE
BOARD OF PATENT APPEALS
AND INTERFERENCES

Appeal No. 2005-1852
Application 09/401,892[1]

ON BRIEF

Before JERRY SMITH, BARRETT, and NAPPI, Administrative Patent Judges.

BARRETT, Administrative Patent Judge.

DECISION ON APPEAL

This is a decision on appeal under 35 U.S.C. § 134(a) from the final rejection of claims 1-22.

We affirm-in-part.

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[1] Application for patent filed September 23, 1999, entitled "Locked/Crossed Quote Handling."

BACKGROUND

The invention relates to a technique for handling quotes in an electronic market that, if entered, would lock or cross other quotes in the market. A locked market occurs when the quoted bid price is the same as the quoted ask price. A crossed market occurs when the quoted bid price is greater than the quoted ask price. The lock/cross manager is described in the specification at pages 19-20.

Claim 1 is reproduced below.

> 1. A method of handling quotes in an electronic market that, if entered, would lock or cross other quotes in the market comprises:
>
> formatting the quote as a marketable limit order and routing the formatted order to a market participant whose quote was locked or crossed.

THE REFERENCES

The examiner relies on the following references:

"Self-Regulatory Organizations: Notice of Filing of Proposed Rule Change and Amendment No. 1 to the Proposed Rule Change by the National Association of Security Dealers, Inc. Relating to Locked and Crossed Markets that Occur at or Prior to the Market's Open," 64 Fed. Reg. 31,335-31,338 (June 10, 1999) (hereinafter "Federal Register").

Biais et al. (Biais), An empirical analysis of the limit order book and the order flow in the Paris Bourse, Journal of Finance, Vol. 50, No. 5, December 1995, pages 1655-1690.

THE REJECTION

Claims 1-22 stand rejected under 35 U.S.C. § 103(a) as being unpatentable over Federal Register and Biais.

We refer to the final rejection (pages referred to as "FR__") and the examiner's answer entered May 4, 2004, (pages referred to as "EA__") for a statement of the examiner's rejection, and to the brief filed March 1, 2004, (pages referred to as "Br__") and reply brief filed July 8, 2004, (pages referred to as "RBr__") for a statement of appellants' arguments thereagainst.

DISCUSSION

Grouping of claims

Appellants group the claims as follows:

Group I: claims 1, 9, and 10.
Group II: claims 2, 11, and 20.
Group III: claims 3, 5, 12, and 13.
Group IV: claims 4, 6, and 14.
Group V: claims 7 and 15.
Group VI: claims 8 and 16.
Group VII: claim 17.
Group VIII: claims 18 and 19.
Group IX: claims 20 and 21.

Claim 20 is grouped with both Groups II and IX and claim 22 is not grouped with any group. Since claim 20 depends on independent claim 17, claim 20 is not properly grouped to stand or fall with the claims in Group II; in any case claim 20 is separately argued in Group IX. Since claim 22 is not argued, it is considered to stand or fall with independent claim 17. Since claim 21 is of different scope than claim 20, it does not logically stand or fall therewith, and since it is not separately argued it stands or falls together with claim 17.

Context

Initially, we note that, at the time of filing, co-inventor Richard G. Ketchum was President of the National Association of Securities Dealers, Inc. ("NASD"), which wholly owns the Nasdaq Stock Market, Inc. ("Nasdaq"). See NASD Rulemaking: SuperMontage, Securities and Exchange Commission Release No. 34-43863, January 19, 2001, www.sec.gov/rules/sro/nd9953o.htm (downloaded October 6, 2005), 89 pages, at pages 2 and 65 n.5 (copy attached) (hereinafter "Release 43863"). The present application is assigned to Nasdaq. Release 43863 describes the SuperMontage proposal of October 1, 1999, and Amendment Nos. 1 and 2, filed October 26 and October 29, 1999, respectively. Since this application's filing date is September 23, 1999, Release 43863 does not describe prior art. Nevertheless, Release 43863 is of interest. Release 43863 describes the Locked/Crossed Markets aspect of the SuperMontage as follows (pages 17-18):

> A locked market occurs when a market participant's bid equals the lowest offer of another market participant. A crossed market occurs when a market participant's bid exceeds the lowest offer of another market participant. Under the NASD's proposal, if a Nasdaq Quoting Market Participant or UTP Exchange enters a quote/order that will lock or cross the market, the SuperMontage will not display the quote/order, but instead will reformat the quote/order as a marketable limit order and enter it into the SuperMontage as a non-directed order for execution. [Footnote omitted.]

See also "Locked/Crossed Markets" at page 46. Thus, not displaying the quote/order, reformatting the quote/order as a

"marketable limit order," and routing it was a feature of the SuperMontage proposal. Since the present application is assigned to Nasdaq and the SuperMontage proposal was a Nasdaq proposal, it does not appear that some third party is trying to hijack the Nasdaq system.

The issue

The main issue is whether reformatting the quote/order as a "marketable limit order" and routing it was taught or suggested by the prior art.

The rejection

The examiner finds that Federal Register does not disclose the step of formatting the quote as "market liability offer" (FR2), presumably referring to either the claimed "marketable limit order" (e.g., claim 1) or the "marketable liability order" (claim 9), and relies on Biais. The examiner finds that Biais teaches formatting quotes as limit orders and concludes that it would have been obvious to one skilled in the art "to perform the step of formatting the quote as a market limit or liability order in order to perform the step of placing the order" (FR2-3).

Contents of the references

Federal Register discusses a proposed amendment to NASD Rule 4613(e) regarding locked and crossed market conditions that occur prior to the market's opening. The existing language of

Rule 4613(e)(1) states that "[a] market shall not, except under extraordinary circumstances, enter or maintain quotations in Nasdaq during normal business hours if [the bid or asked quotation will produce a locked or crossed market]," p. 31335. The amendments provide that a market maker that has entered a bid (ask) quotation that locks/crosses another market maker's quotation(s) or has had its quotation(s) locked/crossed by another market maker must (between 9:20 and 9:29:59) "send through SelectNet to the market maker whose quotes it is locking or crossing a Trade-or-Move Message that is at the receiving market maker's quoted price and that is for at least 5,000 shares," id. "The receiving market participant will then be required to trade in full with the incoming message within 30 seconds or move its quote out of the way within 30 seconds." Page 31336.

Biais discloses (unnumbered page 2, second para.): "Market orders for a larger amount than the depth available at the quotes are not fully executed. Rather they are partially executed at the best price in the book, while the remainder of the order is converted into a limit order at that price."

Analysis

Group I: claims 1, 9, and 10

Appellants argue that neither the Federal Register nor Biais describes or suggests formatting the quote as a marketable limit order and routing the order to a market participant whose quote was locked or crossed (Br9). It is argued that "[n]either of these events [in Federal Register], i.e., trading in full or moving the quote suggest to 'formatting the quote as a marketable limit order and routing the formatted order to a market participant whose quote was locked or crossed'" (Br9).

Although the examiner finds that Federal Register does not teach formatting the quote as a marketable limit order (FR2), it is not so apparent to us. The subject matter is in an esoteric area of securities and stock exchange business methods with which we are unfamiliar and, thus, we proceed cautiously before reversing the rejection. Federal Register indicates that a market maker whose bid (or ask) quotation will produce a locked/crossed market sends a Trade-or-Move Message to the market maker whose quote was locked or crossed (i.e., it is routed) at the receiving market maker's price, and that the receiving market maker can either trade in full or move its quote out of the way. It is not clear why the Trade option of the Trade-or-Move Message is not, in effect, considered a "marketable limit order" by one of ordinary skill in the art because we understand a marketable

limit order to be an order that upon its receipt is executable, and the Trade option of the Trade-or-Move message is certainly executable. Thus, although Federal Register does not specifically mention formatting the quotation as a "marketable limit order," it seems that this is, in effect, what happens by the message. Appellants' arguments regarding Federal Register do not answer our questions. In addition, claim 9 recites that the "marketable limit order" is entered as a "marketable liability order," which implies that a marketable liability order is a type of marketable limit order, and appellants state that "Federal Register (reporting on proposed changes to the Nasdaq Stock Market) certainly teaches marketable liability orders" (Br16), which suggests that Federal Register teaches marketable limit orders. The Trade-or-Move Messages must inherently be formatted. Therefore, it is not clear to us why Federal Register does not teach or suggest the claimed subject matter. Appellants are in the best position to explain why one of ordinary skill in the securities and stock exchange art would not consider the Trade option in Federal Register to be the same as formatting of the bid (ask) quotation into a marketable limit order and how the locked/crossed system of the SuperMontage proposal differs from the Federal Register. Based on our interpretation of Federal Register, we affirm the rejection of claims 1, 9, and 10 over Federal Register alone.

Biais has been considered, but we find that it is not useful. Appellants argue that Biais teaches converting a market order that exceeds the depth available for quotes into a limit order and does not disclose or suggest converting a quote to a market limit order (Br10). It is argued that the examiner has not shown any motivation to combine Federal Register with Biais and the examiner's reasoning, "to perform the step of placing the quote," is inadequate and based on hindsight (Br10-13).

The examiner states that "it is inherent that the market order [in Biais] originated as a quote, so Biais et al anticipate the step of formatting a quote as a market limit order" (EA4). The examiner also states that Biais explains that marketable limit orders provide liquidity which provides sufficient motivation for formatting to marketable limit orders (EA4).

Appellants respond that an "order" is entered on behalf of customers, whereas a "quote" is an obligation undertaken by "market makers" to maintain a buy and sell side of the market, and that Biais does not teach formatting a quote as an order or a marketable limit order (RBr1-2). It is argued that the market order inherently originated as a quote (RBr2-3).

We have considered both sides of the argument and find ourselves in agreement with appellants. While Biais does contain the words "converted" and "limit order," it does not suggest converting a quote into a marketable limit order. In addition,

we do not find the necessary motivation to apply the teachings of Biais in the locked/crossed market scenario. Thus, Biais is not relied upon in the rejection.

Group II: claims 2 and 11[2]

Appellants argue that neither Federal Register nor Biais teach a routing process (Br12-13).

Federal Register teaches sending the Trade-or-Move Message to market makers whose quotations will be locked/crossed (p. 31335), which is considered routing. Accordingly, the rejection of claims 2, 11, and 20 is affirmed.

Group III: claims 3, 5, 12, and 13

Appellants argue that these claims require determining a lock/cross market condition and routing the formatted order to the market participant whose quote would be locked or crossed, which is not taught (Br13).

Federal Register teaches sending the Trade-or-Move Message to market makers whose quotations will be locked/crossed (p. 31335), which requires that a locked/crossed condition is detected and the message routed to the appropriate market maker. The rejection of claims 3, 5, 12, and 13 is affirmed.

[2] Claim 20 is regrouped with Group VII (claim 17).

Group IV: claims 4, 6, and 14

Appellants argue that the references do not teach executing the formatted order against the quote at the side of the market that would have been locked or crossed (Br14).

Federal Register teaches "a Trade-or-Move Message that is at the receiving market maker's quoted price" (italics omitted) (p. 31335), which teaches executing the Trade option at the side of the market that would have been locked/crossed. The rejection of claims 4, 6, and 14 is affirmed.

Group V: claims 7 and 15

Claim 7 is said to be representative and recites determining if the formatted order was filled against the locked/crossed quote. Appellants argue that Federal Register only teaches that the quote is either moved or fully executed and it is not suggested to "determine if the formatted order was filled by execution against the locked or crossed quote" (Br15).

The teaching of determining if the bid (or ask) quotation was fully executed, as opposed to having the quote moved, meets the limitation of "determining if the formatted order was filled by execution against the locked or crossed quote" in claim 7, where "fully executed" is the equivalent of "filled." The rejection of claims 7 and 15 is affirmed.

Group VI: claims 8 and 16

Claim 8 is said to be representative of this group and recites reformatting the formatted order as a displayable quote if the formatted order was not filled. Appellants argue that the examiner provides no basis for the rejection of this claim (Br15). The examiner states that Federal Register teaches that the quote is reformatted if the order is not executed at p. 31335, col. 3, through p. 31336, col. 1 (EA5).

We do not find where Federal Register teaches reformatting the formatted order as a displayable quote if the formatted order was not filled. The cited portion of Federal Register has to do with avoiding a locked/crossed market and not displaying a quote. The rejection of claims 8 and 16 is reversed.

Group VII: claims 17 and 22

Claim 17 recites formatting the quote as a "marketable liability order." Claim 22 is not separately argued and stands or falls together with claim 17. Appellants state that "[w]hile Federal Register (reporting on proposed changes to the Nasdaq Stock Market) certainly teaches marketable liability orders, the examiner concedes that formatting is not present in Federal Register" (Br16) and Biais does not teach formatting liability orders (Br16).

For the reasons stated with respect to claim 1, and because appellants admit that Federal Register teaches marketable

liability orders, which are presumably part of the Trade-or-Move Messages routed to market makers whose quotations will be locked/crossed and which inherently must be formatted, we affirm the rejection of claims 17 and 22.

Group VIII: claims 18 and 19

The rejection of claims 18 and 19 is affirmed for the reasons stated in connection with Group III.

Group IX: claims 20 and 21

The rejection of claim 20 is reversed for the reasons stated in connection with Group VI.

Claim 21 is of different scope than claim 20 and appellants do not separately argue the limitations of claim 21. Therefore, the rejection of claim 21 is deemed to stand or fall together with the rejection of claim 17. The rejection of claim 21 is affirmed.

CONCLUSION

The rejection of claims 1-7, 9-15, 17-19, 21, and 22 is affirmed.

The rejection of claims 8, 16, and 20 is reversed.

No time period for taking any subsequent action in connection with this appeal may be extended under 37 CFR § 1.136(a)(1). See 37 CFR § 1.136(a)(1)(iv) (2004).

AFFIRMED-IN-PART

Jerry Smith
JERRY SMITH
Administrative Patent Judge

Lee E. Barrett
LEE E. BARRETT
Administrative Patent Judge

ROBERT E. NAPPI
Administrative Patent Judge

BOARD OF PATENT APPEALS AND INTERFERENCES

Appeal No. 2005-1852
Application 09/401,892

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U.S. Securities and Exchange Commission

NASD Rulemaking: SuperMontage

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-43863; File No. SR-NASD-99-53)

January 19, 2001

Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the National Association of Securities Dealers, Inc. and Amendment Nos. 1, 2, 3, 4, 5, 6, 7 and 8 Thereto and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 9 Relating to the Establishment of the Nasdaq Order Display Facility and Order Collector Facility and Modifications of the Nasdaq Trading Platform

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I. Introduction

On October 1, 1999, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly-owned subsidiary, the Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act" or "Exchange Act"),[1] and Rule 19b-4 thereunder,[2] proposed rule changes to establish the Nasdaq Order Display Facility ("NODF") and the Order Collector Facility ("OCF") and to modify its primary trading platform, the Nasdaq National Market System ("NNMS"), collectively referred to as the SuperMontage proposal. On October 26 and October 29, 1999, respectively, Nasdaq filed Amendment Nos. 1 and 2 to

the proposal.[3] The SuperMontage proposal and Amendment Nos. 1 and 2 were published for comment in the *Federal Register* on December 6, 1999.[4] On March 16, 2000, Nasdaq filed Amendment No. 3 to the proposal.[5] On March 23, 2000, Nasdaq filed Amendment No. 4 to the proposal,[6] which was published for comment in the *Federal Register* on March 30, 2000.[7] On May 19, 2000, Nasdaq filed Amendment No. 5 to the proposal;[8] on June 7, 2000, Nasdaq filed Amendment No. 6;[9] and on August 8, 2000, Nasdaq filed Amendment No. 7.[10] Amendment Nos. 5, 6 and 7 were published for comment on August 15, 2000.[11] On October 23, 2000, the NASD filed Amendment No. 8,[12] which was published for comment on November 15, 2000.[13] On January 9, 2001, the NASD filed Amendment No. 9.[14] The Commission received 104 comments regarding the proposal.[15] The Commission is approving the SuperMontage proposal, as amended, and is soliciting comments on Amendment No. 9 from interested persons.[16]

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II. Executive Summary

A. Background of the Nasdaq System

The Nasdaq System originated 30 years ago for the purpose of collecting and displaying quotations posted by individual dealers in the over-the-counter market regulated by the NASD, which sponsored the system. Nasdaq's quotation management system currently collects and displays quotations of registered market makers and ECNs that are members of the NASD (collectively, "Nasdaq Quoting Market Participants"). By agreement, Nasdaq also collects and displays quotations in Nasdaq securities from UTP Exchanges.[17]

The existing quotation management system permits each Nasdaq Quoting Market Participant and UTP Exchange to enter a single quotation into the system at any one time. This single quotation may reflect the Nasdaq Quoting Market Participant's or UTP Exchange's proprietary trading interest or customer limit orders handled by that participant, or both.[18] The quotations of Nasdaq Quoting Market Participants and UTP Exchanges are displayed on a quotation montage (arranged by price and time) that can be viewed on a Nasdaq screen, and are disseminated to vendors for further redistribution to broker-dealers and other subscribers.

Other Nasdaq systems facilitate a Nasdaq participant's ability to interact with the quotations of Nasdaq Quoting Market Participants and UTP Exchanges. In 1984, Nasdaq introduced the Small Order Execution System ("SOES"), which allows Nasdaq participants to execute small orders automatically against the quotation of a market maker at the best bid or offer ("BBO").[19] Nasdaq's SelectNet system, introduced in 1988, allows Nasdaq participants to route orders to a particular market maker or ECN.[20] Although SelectNet is an order delivery service, rather than an execution service, a SelectNet order presented to a market maker or ECN at its displayed quotation obligates the market maker or ECN to execute the order at the price and size of its quote consistent with the Commission's Firm Quote Rule.[21] The SOES and SelectNet systems currently are not integrated, so that it is possible for a market maker to receive a SelectNet order that it is obligated to execute and a SOES execution against the same

quote, creating a double liability exposure.[22]

Nasdaq's SOES and SelectNet systems supplement the separate order execution services offered by market makers, ECNs, and UTP Exchanges, but do not supplant those services. In fact, the large majority of orders are executed outside Nasdaq's order delivery and execution services through direct links - by telephone, dedicated line, or other means - among order entry firms, market makers, ECNs, and UTP Exchanges.

In recent years, changes in technology and market structure have placed increasing demands on, and created new challenges for, Nasdaq's systems. For example, while Nasdaq's existing quotation management system displays the best bid and offer of a Nasdaq Quoting Market Participant or UTP Exchange, many market participants are interested in seeing more of a Nasdaq Quoting Market Participant's or UTP Exchange's trading interest outside its best bid and offer. In addition, the entry of ECNs and UTP Exchanges trading Nasdaq securities has increased competition among execution service providers, including Nasdaq.

The changing competitive environment has been accompanied by changes in Nasdaq's structure and ownership. The NASD's ownership of Nasdaq was reduced to 60% on a fully diluted basis by a private placement sale of shares and warrants on June 28, 2000 and was further reduced to 40.6% by a second private placement just completed. The warrants are exercisable over a four year period beginning June 28, 2002. Under the terms of the sale, the voting rights for NASD shares underlying warrants will shift to the warrant holders upon registration of Nasdaq as an exchange. Nasdaq filed an application for registration with the Commission on November 9, 2000 .[23]

Subsequently, the NASD Board adopted a resolution stating its intent to divest itself of all remaining shares of Nasdaq not subject to outstanding warrants by June 30, 2002, subject to existing contractual and legal arrangements and to the reasonable judgment of NASD management that market conditions permit.[24] The NASD also has undertaken that during any interim period it intends to vote its shares in Nasdaq on any matter in proportion to the votes of all other shareholders.

The Commission has considered the SuperMontage proposal in the context of increased demand for information about trading interest, increasing competition among execution service providers, and changes in Nasdaq's ownership structure. The Exchange Act requires the Commission to approve the proposed rule changes if it finds that the changes are consistent with the requirements of the Exchange Act applicable to the NASD.

In this context, including Nasdaq's demutualization, application for registration as an exchange, and impending full separation of the NASD and Nasdaq, and for the reasons discussed in this release, the Commission finds that the proposed rule changes are consistent with the requirements of the Exchange Act applicable to the NASD and therefore approves the proposed rule changes.

B. Overview of the SuperMontage Proposal

The SuperMontage proposal is designed to modify Nasdaq's systems in three principal areas: (1) quote/order collection; (2) quote/order display; and (3) execution services.

1. Quote/Order Collection

SuperMontage will partially eliminate the distinction between quotes and orders and expand the ability of Nasdaq Quoting Market Participants and UTP Exchanges to represent quotes/orders in the Nasdaq market. It will permit, but not require, Nasdaq Quoting Market Participants and UTP Exchanges to enter multiple quotes/orders at the same price or at different prices.[25] In addition, SuperMontage will allow Nasdaq Quoting Market Participants to enter quotes/orders on a non-attributable basis (*i.e.*, anonymously), although market makers will be obligated to maintain a two-sided attributable quote/order consistent with Commission and NASD rules. UTP Exchanges will not be permitted to enter principal quotes on a non-attributable basis, but may enter agency quotes/orders on a non-attributable basis.

For Nasdaq Quoting Market Participants and UTP Exchanges that choose to enter multiple quotes/orders, SuperMontage will aggregate their best-priced attributable quotes/orders on each side of the market to create the Nasdaq Quoting Market Participant's or UTP Exchange's displayed quote, while maintaining the separate identity, price, and time of entry of each quote/order. Alternatively, a Nasdaq Quoting Market Participant or UTP Exchange may choose to maintain only its required quotation, and not enter additional quotes/orders.

2. Display of Quotes/Orders

To the extent Nasdaq Quoting Market Participants and UTP Exchanges use the quote/order collection system to represent more quotes and orders than they currently are able to represent, SuperMontage will show more information than the current quotation montage. SuperMontage will display the additional information in two ways. First, the best-priced non-attributable quotes/orders from all participants will be aggregated and displayed in the quotation montage as one buy and one sell price, each under the generic name "SIZE", along with the best-priced attributable quotes/orders of each Nasdaq Quoting Market Participant and UTP Exchange. Second, and more significantly, SuperMontage will aggregate all quotes/orders (attributable and non-attributable) at each price level, and display the three best prices with associated aggregate size on each side of the market through the NODF. This information will be distributed to market data vendors so that they can provide an equivalent display service to their customers. In addition, the NASD will make available to market data vendors individual attributable quotes/orders displayed in the three best price levels in the NODF.

Thus, to the extent Nasdaq Quoting Market Participants and UTP Exchanges voluntarily enter their "near the market" quotes/orders, investors and market professionals will be able to see the aggregate of this interest at three price levels in widely available displays.

3. Execution Services

SuperMontage will replace Nasdaq's current SOES and SelectNet services with two new processes: a directed order process and a non-directed order process. Nasdaq participants that wish to use either of these processes to interact with the quotes/orders of Nasdaq Quoting Market Participants and UTP Exchanges may enter orders into the same order collection facility used by Nasdaq Quoting Market Participants and UTP Exchanges to enter quotes/orders.

The directed order process will be functionally similar to the current SelectNet service in that it will allow a Nasdaq participant to direct an order to a particular Nasdaq Quoting Market Participant or UTP Exchange. As in SelectNet, a directed order can match a posted quote/order of the recipient (a Liability Order) or not match any quote/order of the recipient (a non-Liability Order).[26] To avoid creating a risk of double liability, no Nasdaq Quoting Market Participant or UTP Exchange is required to receive directed Liability Orders through the OCF, but may elect to do so.

The non-directed order process will be the default execution process for marketable orders entered by a Nasdaq participant into Nasdaq's order collection facility. A marketable order entered into the non-directed order process will be matched with the highest ranked quotes/orders of Nasdaq Quoting Market Participants and UTP Exchanges on the opposite side of the market, and either will be executed automatically or delivered (on a liability basis) to the matched Nasdaq Quoting Participants and UTP Exchanges, depending upon how such participants participate in the non-directed order process.[27]

The ranking of Nasdaq Quoting Market Participant and UTP Exchange quotes/orders in the non-directed order process will be established pursuant to one of three order execution algorithms: price/time priority, price/size/time priority, or price/time priority that account for ECN fees. The Nasdaq participant entering a non-directed order may select the algorithm used for executing its order, but the system will default to the price/time priority algorithm if none is selected. Within each algorithm, a non-directed order entered by a Nasdaq participant that is also a Nasdaq Quoting Market Participant will be matched first against its own quote/order on the other side of the market, provided that its quote/order is at the BBO. In addition, a Nasdaq participant entering a non-directed order will be permitted to "preference" the order to a particular Nasdaq Quoting Market Participant or UTP Exchange, if that participant's quote/order is at the BBO.

Nasdaq participants are not required to use either the directed or non-directed order processes to execute their orders but may choose, instead, systematically or on an order-by-order basis, to continue to use other methods such as telephone access or direct connections to market makers, ECNs, and UTP Exchanges. Any Nasdaq member is free to offer a competing execution service, and may even use the Nasdaq service as one of its options.

C. Summary of Conclusions

The SuperMontage proposal generated significant controversy. Throughout a series of comment periods and revisions, commenters maintained that various aspects of the proposal were unfair or anti-competitive, and that the proposal as a whole fell short of the standards that ought to be required of National Market System facilities.

Many issues were resolved through the process of public comment and response. For example, under the original proposal Nasdaq Quoting Market Participants would have transmitted to Nasdaq multiple quotes/orders at the same price or at different prices, and Nasdaq would have aggregated the best priced orders on either side of the market to produce the participant's required quotation, which would then be distributed by Nasdaq, in its capacity as an exclusive processor for the OTC market.

In addition, Nasdaq would have distributed the aggregate amount of buying

and selling interest at the three best price levels on either side of the market. Some commenters objected that the proposal in this form meant that Nasdaq alone would know the details of any quotes/orders not incorporated into participant quotations, and that it would be unfair for Nasdaq to keep such information to itself. In response, Nasdaq agreed to disseminate the details of all attributable quotes/orders in the three best price levels on either side of the market via a new information service, in addition to the aggregate amounts of interest at those prices. The result will be that all quote/order details will be generally available at the best price levels, except those quotes/orders that are submitted on an anonymous basis (non-attributable quotes/orders). The Commission believes that this additional information will be valuable to competitors that may offer execution services complementary to, or in competition with, Nasdaq's SuperMontage services, and that Nasdaq's proposal appropriately resolves the issue. Several other issues have been dealt with in similar fashion. All of these are described at length in the Discussion section below.

The remaining issues, which remain controversial, generally fall in two groups: 1) disagreements about the appropriate priority and protections afforded to quotes/orders represented in SuperMontage under the applicable execution procedures, and 2) questions concerning the conflicts inherent in NASD's multiple roles as SRO and default regulator for the OTC market, and as the principal owner of Nasdaq, which will be the operator of SuperMontage. These issues have been carefully weighed by the Commission and are described individually and in detail in the Discussion section below. A more general description and overview of the Commission's analysis and reasoning follow:

1. Execution Procedures and Quote/Order Priority

Following Amendment No. 7, the proposed execution procedures involved a single execution algorithm for non-directed orders (without any preferencing), and the directed order process. Preferencing through the non-directed order process had not yet been proposed. The single execution algorithm applicable to non-directed orders was based on price/time priority, but gave lower priority to quotes/orders of an ECN that charges a separate fee for accessing its quotes/orders, and last priority to the principal quotes of UTP Exchange specialists.[28] Some ECNs and others objected to the treatment of quotes/orders involving payment of a separate fee, arguing among other things that many market participants preferred to deal with ECNs, even if they charged fees, because statistically the price improvement provided by certain ECNs exceeded the cost of their fees. Some also maintained that only displayed prices should be considered in assigning priority because any associated fees would be paid by brokers and not by customers. Still others argued that Nasdaq should not assign any priorities to quotes/orders but should only provide a means to access displayed quotes and leave the choice of priorities to participants.

In response to these arguments and others, the NASD in Amendment No. 8 proposed to offer participants much greater control of the execution process by creating two additional execution algorithms using price/time and price/size/time priorities respectively, ignoring any separate fees, and by creating the ability to send preferenced orders to any Nasdaq Quoting Market Participant or UTP Exchange at the discretion of the entering firm. This response was satisfactory to some earlier commenters that had sought greater control of the execution process, but not to certain ECNs that had wanted the execution process to ignore access fees. Moreover, the new approach embodied in Amendment No. 8 brought new objections from some commenters that it would be a step backward in achieving price/time

priority that would encourage price competition.

The Commission believes that the competing interests of Nasdaq participants with respect to some of the issues of priority are essentially irreconcilable. For example, there is no way to simultaneously satisfy both those ECNs that want their orders executed and fees assessed when their orders have time priority at the displayed price, and other participants that want to avoid paying such fees when they can receive a better net price from other orders that do not have time priority. The Commission recognizes that there is merit to both sides of the discussion, but it believes that price priority ordinarily must take precedence over time priority. Because a quote that involves payment of a separate fee is, all other things equal, inferior to a quote at the same displayed price that does not involve payment of a fee, the Commission believes that it is reasonable to allow market participants to choose a method of execution that gives lower priority to quotes that require payment of a fee. It is true that price improvement may sometimes exceed the value of the required fee, but the fee is certain while price improvement is uncertain. The Commission believes that market participants are best able to exercise judgment in such cases.

The Commission shares the view expressed by some commenters that price/time priority tends to encourage price competition. The Commission notes, however, that although price priority is generally followed in the Nasdaq market, there is at present virtually no time priority across market centers. The proposal, in its present form, provides for more time priority than currently exists in the market, and may to that extent encourage more price competition. Moreover, for the reasons outlined above, a displayed price does not always represent the actual price to a participant and, indeed, the actual price is often not the same for all participants that might execute against a particular quote.[29] The Commission does not believe that it is appropriate to require strict time priority based on such prices.

For these reasons, the Commission finds that the combination of choices offered in the current proposal is both fair to participants and reasonably designed to promote competition.

2. Inherent Conflicts of NASD Roles

Many commenters raised issues that relate in one way or another to the multiple roles that the NASD has as an SRO and, through Nasdaq, as an exclusive processor of market information and as an operator of trading facilities. The Commission notes that conflicting roles are inherent in the self-regulatory model. Indeed, the Act specifically recognizes that SROs will act not only as regulators, but also as operators of markets, and exclusive processors of information derived from those markets. The Act authorizes the Commission to oversee SRO functions to address the inherent conflicts, and to ensure, among other things, that SROs do not abuse their regulatory powers,[30] and when acting as exclusive processors, make available market information in a non-discriminatory, fair, and reasonable fashion. Thus, the Commission's role is to reach a fair and appropriate balance of the conflicts inherent in the SRO structure, not to eliminate those conflicts.

Prior to Amendment No. 8, many objections were raised that SuperMontage, as then proposed, would become a centralized, monopolistic execution system. The gist of these arguments was that because NASD is the default regulator for the OTC market,[31] any market maker or ECN that wished to do business in Nasdaq securities must make its quotes available

for execution through SuperMontage. Thus, SuperMontage would be, by the effect of NASD and Commission rules, the only execution system through which substantially all displayed trading interest could be reached. The only exception would have been any UTP Exchanges that chose not to participate in SuperMontage.

In response to these concerns, the NASD has agreed to provide an alternative quotation and transaction reporting facility for NASD members, including alternative trading systems ("ATSs"), ECNs, and market makers. In effect, this facility makes participation in SuperMontage voluntary. This facility will permit NASD members to comply with their obligations under Commission and NASD rules (including Rule 11Ac1-1(c)(5) and Regulation ATS) without participating in the Nasdaq execution facility. The facility will identify through the central processor the identity of the NASD member that is the source of each quote.[32] The facility also will provide a market neutral linkage to the Nasdaq and other marketplaces, but not an execution service. NASD represents that the facility will be available upon the implementation of SuperMontage by Nasdaq. The Commission believes that this undertaking by NASD, in conjunction with other terms applicable to the NASD's interaction with the SuperMontage,[33] provides an appropriate balance of NASD's role as regulator of the OTC market and its role (through Nasdaq) as operator of an execution service in a competitive market.

Some commenters also argued that automatic execution against market makers would give the SuperMontage an unfair advantage in attracting order flow, and make it difficult for others to offer competitive execution services. It appears that inherent in this argument is the view that Nasdaq should not be permitted to require its registered market makers to accept automatic executions, or that Nasdaq should not be permitted to operate a market itself, but should be restricted to providing connections among market makers and ECNs. Although the Commission is sensitive to the need to ensure that competition is fair, it cannot accept the view that Nasdaq should not be allowed to operate a market in which its registered market makers are required to accept automatic executions, particularly when participation in that market is voluntary. The Commission notes that compulsory automatic executions have been a feature of the Nasdaq market since at least 1988.[34] The "SuperSOES" proposal approved in January 2000 further expanded the scope of automatic execution against market maker quotes. The Commission therefore finds that the requirement that registered market makers in Nasdaq accept automatic executions against their published quotes is not a new feature of the SuperMontage and that it remains an appropriate feature of a system designed to provide economically efficient executions to investors within a fair and orderly market.

Some commenters argued that Nasdaq's role as the exclusive processor of information for Nasdaq-listed securities will give SuperMontage an unfair advantage. On close examination, these criticisms pertained less to the operation of SuperMontage than to the requirement that market makers and ECNs quote through Nasdaq, as the sole consolidator of market data for Nasdaq securities. To address this issue, the NASD has agreed to provide an alternative quote and trade reporting mechanism, while Nasdaq has said that it is willing to confer with the other markets about establishing a separate central processor for information on Nasdaq securities under the UTP Plan.[35] Nevertheless, the Commission believes that the current UTP plan must be revised to provide for a fair competitive environment in the future for all market centers trading in Nasdaq securities.[36] The Commission believes that these undertakings, which are discussed in detail

below, appropriately address the concerns about an advantage to Nasdaq arising from its role as the exclusive processor for Nasdaq securities.

Finally, the Commission believes that Nasdaq, as well as the traditional exchanges, must have the flexibility to alter their existing services and to create new services in response to changes in the marketplace. Congress instructed the Commission to seek to "enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services."[37] The Commission believes that the SuperMontage proposal is consistent with these goals.

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III. Description of the Proposal

The SuperMontage proposal will enhance Nasdaq's quotation montage by adding a new display facility for trading interest, the NODF, and establishing a new system for collecting quotes/orders, the OCF. This proposal also will modify Nasdaq's primary trading platform, the NNMS, as approved on January 14, 2000.[38]

A. Nasdaq Order Display Facility

Today, the Nasdaq screen, commonly referred to as the Nasdaq Workstation II ("NWII"), is split into two primary display components. The top portion of the NWII contains, among other things: (1) the Market Minder Window, which allows market participants to monitor price activity (inside bid/offer and last sale) of selected stocks; and (2) the Dynamic Quote Window, which shows for a particular stock the inside bid and offer, the last sale, change in price from previous close, daily high and low, volume, and the short sale arrow indicator. The bottom portion of the NWII contains the Nasdaq Quotation Montage. The Nasdaq Quotation Montage shows for a particular stock two columns (one for bids, one for offers), under which is listed the market maker identification ("MMID") for each registered market maker, ECN, and UTP Exchange in the stock, and the corresponding quote (price and size). Nasdaq ranks the bids and offers along with the corresponding MMID in price/time priority. Accordingly, the market participant at the best bid who is first in time appears first in the montage, the market participant at the best bid (or the next best bid) who is next in time is ranked second, and so on.

Market makers that choose to participate in Nasdaq are required to submit a two-sided principal quote,[39] which may reflect customer limit orders held by the market maker. ECNs, to qualify under the Order Handling Rules, must submit the prices and sizes of orders at the highest buy price and lowest sell price entered into the ECN by market makers.[40] UTP Exchanges that have an interface with Nasdaq are required under the UTP Plan to submit to Nasdaq a two-sided quote, which represents the exchange's best quote in the stock at issue.

1. Enhanced Display of Trading Interest

Under the proposal, Nasdaq will retain the bottom portion of the NWII, the Nasdaq Quotation Montage, which displays market maker, ECN and UTP Exchange attributable quotes ranked in price/time priority. Nasdaq

proposes to add the NODF, which will be displayed in the top portion of the NWII. The NODF will display the three best price levels in Nasdaq on both the bid and offer side of the market. These displayed price levels will include, for the first time in the Nasdaq market, anonymous (or non-attributable) quotes/orders in addition to the attributable quotes/orders of market makers, ECNs, and UTP Exchanges. Each price level will be updated and will display the aggregate size of displayed trading interest (attributable and non-attributable, as explained below). In addition to displaying the aggregate size of displayed trading interest at the three best price levels, Nasdaq will create and make available a new vendor data feed called NQDS Prime. NQDS Prime will provide, on a real-time basis, all individual attributable quote/order information at the three best price levels displayed in the NODF.[41]

Nasdaq Quoting Market Participants will be required to designate a quote/order as attributable or non-attributable[42] and will be able to indicate a reserve size for the quote/order.[43] If a quote/order is designated as attributable, the price and size of the quote/order will be displayed next to the Nasdaq Quoting Market Participant or UTP Exchange's MMID in the Nasdaq Quotation Montage if it is the Nasdaq Quoting Market Participant or UTP Exchange's best-priced attributable quote/order. Attributable quotes/orders will be displayed in the NODF as part of the aggregate trading interest when the price of the quote/order is within the best three price levels (on either side of the market) in Nasdaq.

If a quote/order is designated as non-attributable, it will be displayed in the NODF as part of the aggregate trading interest when it is within the best three price levels. That quote/order will not, however, be displayed in the Nasdaq Quotation Montage next to the Nasdaq Quoting Market Participant's or UTP Exchange's MMID but instead may be displayed in a special "SIZE MMID," which is described in greater detail below, representing the aggregate size of the best priced non-attributable bids or offers. Pursuant to NASD Rule 4613, market makers will continue to be required to publish a two-sided quote that is attributed to their MMID in the Nasdaq Quotation Montage.

2. SIZE MMID and Summary Scan

A SIZE MMID, representing the aggregate displayed size of the best-priced non-attributable bids or offers, will be shown in the Nasdaq Quotation Montage along with the other MMIDs for the Nasdaq Quoting Market Participants and UTP Exchanges displaying attributable size. The bid side and the offer side of the market each will have one SIZE MMID.[44]

The SuperMontage also will include a "Summary Scan" function. The Summary Scan will be a query-only function that will provide a snapshot of the total displayed size (attributable and non-attributable) for all levels below the three price levels in the NODF. The Summary Scan will anonymously display the aggregate interest (attributable and non-attributable) at each price level on both sides of the market, but will not be dynamically updated.

3. Reserve Size

Nasdaq Quoting Market Participants will be able to use reserve size. According to the NASD, reserve size will work in virtually the same manner as approved in the NNMS Order.[45] A Nasdaq Quoting Market Participant will be required to display (either as attributable or non-attributable) 1,000

shares in order to use reserve size. Reserve size will replenish displayed size (attributable or non-attributable) by at least 1,000 shares once displayed size is decremented to zero. Reserve size, along with displayed (both attributable and non-attributable) size, will be accessible through Nasdaq's trading platform, the NNMS. Reserve size, however, will not be displayed in either the NODF or the Nasdaq Quotation Montage. As described further below in the Order Execution Algorithms section of this Order, reserve size generally will be accessed after all displayed size at a given price in the Nasdaq market is exhausted.[46]

B. Order Collector Facility

Nasdaq proposes to establish an OCF as part of the SuperMontage that will : (1) transmit to Nasdaq multiple quotes/orders at one price or quotes/orders at multiple price levels entered by Nasdaq Quoting Market Participants and UTP Exchanges;[47] (2) accept orders to access quotes/orders displayed (as either attributable or non-attributable) in both the NODF and the Nasdaq Quotation Montage; and (3) unify Nasdaq's delivery of Liability Orders to Nasdaq Quoting Market Participants and UTP Exchanges,[48] which should minimize the potential for dual liability.

1. Entry of Quotes/Orders

Nasdaq proposes to allow Nasdaq Quoting Market Participants and UTP Exchanges to transmit multiple quotes/orders and quotes/orders at multiple price levels (subject to restrictions on a UTP Exchange's ability to send multiple quotes/orders for principal quotes/orders), which the system will manage and display in the SuperMontage consistent with a quote/order's parameters. Nasdaq will time stamp each quote/order upon receipt, and the time stamp will be used in determining the ranking of the quote/order for execution purposes. If a size increment is received from a Nasdaq Quoting Market Participant for an existing quote/order at a given price, the system will maintain the original time stamp for the original quantity and assign a separate time stamp for the augmentation, thus protecting the time priority of the originally-entered quantity. Subsequent decreases in size will be deducted from individually stamped components in reverse time priority. Once a displayed size is diminished to zero, however, the quote/order will no longer retain priority, although it may have a feature that automatically refreshes size.[49]

In addition, a Nasdaq Quoting Market Participant will designate a quote/order as either attributable or non-attributable, and could designate a reserve size.[50] As noted above, for attributable quotes/orders, the prices and sizes of a Nasdaq Quoting Market Participant's or UTP Exchange's best-priced attributable quotes/orders on both the bid and offer side will be aggregated and displayed in the Nasdaq Quotation Montage under the participant's MMID, and also will be included in aggregate trading interest displayed in the NODF if the quotes/orders fall within the three best price levels (on either side of the market) in Nasdaq. For non-attributable quotes/orders, Nasdaq will display the aggregate size of such quotes/orders in the NODF when the quotes/orders fall within the three best price levels (on either side of the market) in Nasdaq. In addition, the best-priced non-attributable quotes/orders from all Nasdaq Quoting Market Participants and UTP Exchanges will be aggregated and displayed next to the SIZE MMID in the Nasdaq Quotation Montage.

The proposal will not require Nasdaq Quoting Market Participants and UTP Exchanges to post multiple quotes/orders at multiple price levels. A market

maker could continue to send only its best bid/best offer to Nasdaq, and an ECN could continue to send Nasdaq only its top of the book. In addition, UTP Exchanges may elect to provide only their best quotes for display in the Nasdaq Quoting Montage.[51]

2. Order Execution and Delivery

Even under NNMS (*i.e.*, the SOES and SelectNet integration), the SOES and SelectNet systems continue to operate on separate platforms, and from the end-user's perspective there are still two separate systems.[52] In order to further integrate the systems and minimize the potential for market maker dual liability, Nasdaq proposes to route all Liability and non-Liability Orders in the Nasdaq system through the OCF portion of the SuperMontage.

To access quotes/orders through the OCF, order entry firms, market makers, ECNs, and UTP Exchanges may enter either a directed or non-directed (including preferenced) order into the OCF.[53] The order can be up to 999,999 shares (there will be a separate odd-lot process), and must indicate whether it is a buy, sell, sell short, or sell short exempt order.[54] The order must be a priced or market order. Non-directed orders entered by order-entry firms will be designated as immediate or cancel orders. Orders entered by Nasdaq Quoting Market Participants or UTP Exchanges may be designated as immediate or cancel.[55]

Nasdaq will affix the MMID of the sender to all delivered orders. Further, preferenced orders and non-directed orders that are executed against a market maker or other market participant that participates in the automatic execution functionality of the system will result in an execution report being sent to each party to the trade immediately upon execution that identifies all counterparties to the trade. This is true whether a non-directed order is executed against an attributable quote/order or a non-attributable quote/order.[56]

The NASD represents that the SuperMontage improves the current SelectNet order cancellation process for ECNs and other participants that take order delivery. Today, a firm entering an order into SelectNet can cancel the order after 10 seconds regardless of the order's status -- *i.e.*, regardless of whether the market participant that received the order is attempting to execute the order. In SuperMontage, an order that is in delivery to an ECN or UTP Exchange cannot be canceled. Thus, if a market participant requests to cancel an order that has been delivered to an ECN or UTP Exchange, the system will hold the cancel request until the ECN or UTP Exchange has completed interacting with the delivered order (*i.e.*, once the ECN or UTP Exchange executes, partially executes, or declines the order) or fails to respond within the allowable time. For example, if an order is delivered to an ECN and the entering market participant requests to cancel, the system will hold the cancel request. If the ECN declines or partially executes the order, the cancel request will be honored, thus canceling the original order (or the unexecuted balance of the original order for partially-executed orders).[57]

C. Non-Directed Orders

Under the proposal, a market participant will be able to immediately access the best prices in Nasdaq by entering a non-directed order into the OCF. A non-directed order is an order that the market participant does not route to a particular Nasdaq Quoting Market Participant or UTP Exchange, or a

preferenced order (as further described below). A non-directed order must be a market order or a marketable limit order.[58] Upon receipt of a non-directed order that is not a preferenced order, the OCF will ascertain the next Nasdaq Quoting Market Participant or UTP Exchange in the queue due to receive an order pursuant to one of three Order Execution Algorithms and deliver either an execution or a Liability Order, depending on how the Nasdaq Quoting Market Participant or UTP Exchange participates in Nasdaq.[59] However, as described below in the Order Execution Algorithms section of this Order, a Nasdaq Quoting Market Participant's non-directed orders first will be matched against its own quotes/orders if the participant is at the Nasdaq BBO.

A new type of non-directed order called a "preferenced order" also can be entered into the non-directed order process, and will be considered a Liability Order. The market participant entering the preferenced order must designate the particular Nasdaq Quoting Market Participant or UTP Exchange against which the order is to be executed or delivered. When a preferenced order is next to be executed within the non-directed order queue it will be delivered to the designated party as an order or as an execution depending on how the party participates in Nasdaq. The SuperMontage will execute against (or deliver an order in an amount up to) both the displayed and reserve size of the preferenced Nasdaq Quoting Market Participant or UTP Exchange, but only if it is at the BBO. Any unexecuted portion will be returned to the entering market participant.[60]

1. Quote Decrementation of Non-Directed Orders

For Nasdaq Quoting Market Participants and UTP Exchanges accepting automatic executions, the SuperMontage will deliver an execution up to the size displayed by the participant, then to other displayed orders at that price, and then to the participant's reserve size (if any).[61] The SuperMontage will automatically decrement the aggregate quote in the NODF by the size of the delivered execution, and decrement the Nasdaq Quoting Market Participant's or UTP Exchange's quote/order in the Nasdaq Quotation Montage if the quote/order is attributable. Displayed (attributable or non-attributable) size will be replenished from reserve size for Nasdaq Quoting Market Participants accepting automatic executions if the participant's displayed size has been decremented to zero and the participant has reserve size. If an ECN accepts automatic executions and its attributable quotes/orders and reserve sizes are exhausted without the ECN updating or transmitting another attributable quote/order to Nasdaq, Nasdaq will zero out the side of the quote that is exhausted. If both sides of the ECN's quote are reduced to zero without the ECN updating or transmitting another attributable quote/order, the ECN will be placed into an excused withdrawal state until the ECN transmits a revised attributable quote/order to Nasdaq. However, Nasdaq will continue to access any non-attributable quotes/orders in NNMS while the ECN is in an excused withdrawal state.

For Nasdaq Quoting Market Participants and UTP Exchanges not participating in automatic executions (*i.e.*, order delivery ECNs and UTP Exchanges), Nasdaq will deliver a Liability Order. Nasdaq will automatically decrement the participant's quote by the size of the delivered order and the remaining quote, if not decremented to zero, will retain its priority in the queue.[62]

If an order delivery ECN or UTP Exchange declines or partially fills an order, or fails to respond in any manner within thirty seconds of order delivery,

Nasdaq will immediately re-route the order (or unexecuted portion thereof) to the next Nasdaq Quoting Market Participant or UTP Exchange in the queue.[63] In addition, in the case of an order delivery ECN that has declined or partially filled an order without immediately transmitting a revised quote/order or that has failed to respond within 30 seconds, Nasdaq will zero out the ECN's quotes/orders at that price level on that side of the market. In the case of an order delivery UTP Exchange that has declined or partially filled an order without immediately transmitting a revised quote/order or that has failed to respond within 30 seconds, Nasdaq will move the side of the UTP Exchange's quote/order, to which the declined or partially filled order was delivered, to the lowest bid or highest offer in Nasdaq for 100 shares.[64]

Nasdaq also will apply a shorter uniform turn-around standard of a maximum of 5 seconds to order delivery ECNs. The purpose is to establish a general standard (as opposed to an order-by-order standard) that measures whether an ECN is providing an automated response in a time period that ensures market quality. Thus, Nasdaq proposes to monitor an ECN's order turnaround time based on information received from the ECN's Nasdaq Service Display Platform ("SDP"). Nasdaq will use SDPs linked to each ECN to assign a time-stamp for when an order is delivered to the ECN. Nasdaq also will capture the time-stamp via the SDP of when the ECN sends a response to the delivered order. Nasdaq will then calculate and monitor, on a real-time basis, the difference between the two time stamps and determine whether the ECN is meeting the 5 second maximum order-response standard. On an ongoing basis, Nasdaq will monitor ECN response times and provide each ECN with its own order responsiveness time statistics, which will not be made public. If an ECN regularly fails to meet the 5 second response time over a number of orders, Nasdaq will place that ECN's quote in a closed quote state. The closed quote state will be lifted when the ECN can certify that it can meet the 5 second response time requirement.[65]

2. Quote Refresh and Revised SOESed-Out-of-the-Box Procedures

As noted previously, market makers are required to maintain a two-sided, attributable principal quote in Nasdaq at all times. To assist with this requirement, market makers will be able to use the Quote Refresh ("QR") function.[66] QR allows a market maker to designate a refresh size (with a default refresh size of 1,000 shares) and price (*e.g.*, a tick amount away from the price of its decremented quote) to which it wishes to refresh if its quoted size is decremented to zero. If a market maker is using QR but has an attributable quote/order in the system that is priced at or better than the quote that will be created by the QR, Nasdaq will display the better-priced or equally-priced attributable quote/order that is already in the system, not the QR-produced quote. If a market maker is not using QR and the market maker has given Nasdaq multiple attributable quotes/orders, Nasdaq will display the market maker's next best-priced attributable quote/order when its best-priced attributable quote/order is decremented to zero.

If a market maker's quote/order is decremented to zero and the market maker does not update its principal quote via QR, transmit a revised attributable quote/order to Nasdaq, or have another attributable quote/order in the system, Nasdaq will place the market maker's quote (both sides) in a closed state for three minutes. At the end of that time, if the market maker did not voluntarily update or withdraw its quote from the market, Nasdaq will refresh the market maker's quote/order to its normal

unit of trading (generally 100 shares) at the lowest bid and highest offer currently being displayed in that security and reopen the market maker's quote.[67]

D. Order Execution Algorithms

The Order Execution Algorithm was substantially modified by Amendment Nos. 4, 6, 7, and 8 to the proposal. *See supra* notes 6, 9, 10, and 12.

The OCF will execute non-directed orders, other than preferenced orders, against Nasdaq Quoting Market Participant's and UTP Exchange's quotes/orders based on price/time priority unless the market participant chooses to override this default algorithm and select one of the alternative algorithms made available by the OCF. These alternative algorithms are: (1) price/size/time priority; and (2) price/time priority that accounts for ECN quote access fees.

In the price/time algorithm, non-directed orders other than preferenced orders will be executed (within each price level) as follows: displayed quotes/orders of market makers, ECNs, and non-attributable agency interest of UTP Exchanges, in time priority; (2) reserve size of market makers and ECNs, in time priority; and (3) principal quotes of UTP Exchanges, in time priority.[69]

In the alternative order execution algorithm based on price/size/time priority, non-directed orders other than preferenced orders will be processed (within each price level) as follows: (1) displayed quotes/orders of market makers, ECNs, and non-attributable agency interest of UTP Exchanges, in size/time priority; (2) reserve size of market makers and ECNs, in size/time priority, with size priority based on the size of the related displayed quote/order; and (3) principal quotes of UTP Exchanges, in size/time priority.

As a third choice, market participants will be able to indicate that their order should be executed in a manner that accounts for an ECN's separate quote access fee.[70] Under this option, non-directed orders other than preferenced orders will be executed (within each price level) as follows: (1) displayed quotes/orders of market makers, ECNs that do not charge a separate quote access fee, and non-attributable agency interest of UTP Exchanges, as well as quotes/orders of ECNs that charge a separate quote access fee where the ECN indicates that the price improvement offered by the quote/order is equal to or exceeds the quote access fee, in time priority; (2) displayed quotes/orders of ECNs that charge a separate quote access fee to non-subscribers that do not indicate that the price improvement offered by the specific quote/order is equal to or exceeds the access fee, in time priority;[71] (3) reserve size of market makers and ECNs that do not charge a separate quote access fee to non-subscribers, as well as reserve size of quotes/orders from ECNs that charge a separate quote access fee to non-subscribers where the ECN entering such quote/order has indicated that the price improvement offered by the specific quote/order is equal to or exceeds the quote access fee, in time priority; (4) reserve size of ECNs that charge a separate quote access fee to non-subscribers that do not indicate that the price improvement offered by the specific quote/order is equal to or exceeds the quote access fee, in time priority; and (5) the principal interest of UTP Exchanges, in time priority.

Each of these algorithms will make an exception for non-directed, non-preferenced orders entered by a Nasdaq Quoting Market Participant when

that Nasdaq Quoting Market Participant's quote/order is at the inside market. In that case, the SuperMontage will first attempt to match orders entered by the Nasdaq Quoting Market Participant against its own quote/order if the Nasdaq Quoting Market Participant is at the BBO. Finally, market participants may preference an order to a Nasdaq Quoting Market Participant or UTP Exchange at the BBO, as described above.

In all three algorithms, there will be a five-second interval delay in certain instances before an order moves to the next price level. As a general rule, where an order might be partially filled at one price level but the remaining shares of the order will not be filled in full within the next two minimum trading increments (*i.e.*, price ticks) away, there will be a five-second interval delay or pause before the order moves to the next price level. At any point after a delay, if the remainder of the order can be entirely filled within the next two price ticks away, there will be no further delays and the order will be filled completely. Thus, a large market order moving through many price levels could pause for five seconds before every price move except for the last two.[72]

To reduce these interval delays, a market participant will be able to designate an individual order as a "Sweep Order." A Sweep Order will trade through all interest (*i.e.*, displayed and reserve interest) at the three price levels being displayed in the NODF at the time of entry, without pausing five seconds between each displayed price. If the order is not executed in full at the third price level, the order will pause for five seconds between each subsequent price level.[73]

E. Directed Orders

A directed order is one that is routed by the market participant entering the order to a specific Nasdaq Quoting Market Participant or UTP Exchange. Unless the participant to which a directed order is being sent has agreed to accept directed orders that are Liability Orders, a directed order must be a non-Liability Order, and as such, must be designated as: (1) All-or-None ("AON") with a size at least one unit of trading greater than the size of the attributable quote/order of the market participant to which the order is directed; or (2) a Minimum Acceptable Quantity order ("MAQ") with a MAQ value of at least one unit of trading greater than the size of the attributable quote/order of the participant to which the order is directed. If a Nasdaq Quoting Market Participant or UTP Exchange is at the inside or is displaying (attributable or non-attributable) interest in the NODF and receives a directed non-Liability Order that it wants to fill, to avoid double execution, it may request to cancel its displayed quote/order in Nasdaq before it fills the non-Liability Order. Nasdaq will not decrement a quote/order upon the delivery of a directed non-Liability Order.

Nasdaq Quoting Market Participants and UTP Exchanges also can elect to receive directed orders that are Liability Orders (*i.e.*, orders that when delivered to market participants' quotes/orders impose an obligation to respond in a manner consistent with the Commission's Firm Quote Rule).[74] If a market participant chooses to accept directed Liability Orders, Nasdaq will append an indicator to the Nasdaq Quoting Market Participant's or UTP Exchange's MMID, showing that the market participant is available to receive directed Liability Orders.

F. Locked/Crossed Markets

A locked market occurs when a market participant's bid equals the lowest

offer of another market participant. A crossed market occurs when a market participant's bid exceeds the lowest offer of another market participant. Under the NASD's proposal, if a Nasdaq Quoting Market Participant or UTP Exchange enters a quote/order that will lock or cross the market, the SuperMontage will not display the quote/order, but instead will reformat the quote/order as a marketable limit order and enter it into the SuperMontage as a non-directed order for execution.[75] The reformatted order will be routed to the displayed quote/order (attributable or non-attributable) next in the queue that will be locked or crossed, and the order will be executed at the price of the displayed quote/order. Once the lock or cross is cleared, if the Nasdaq Quoting Market Participant's or UTP Exchange's quote/order that would have locked or crossed the market has not been completely filled, the SuperMontage will reformat the order again and display it (consistent with the parameters of the quote/order) as a quote/order on behalf of the entering Nasdaq Quoting Market Participant or UTP Exchange. It should be noted, however, that a market participant will receive a system warning (as it does today) if it attempts to send a quote/order that will lock or cross the market. To complete the order entry, the participant will be required to override the system warning. This override will help market participants avoid automatic executions resulting from inadvertent locking or crossing quotes/orders by not overriding the system warning.[76]

If the market is locked or crossed at 9:30 a.m., Nasdaq will clear out the locked or crossed quotes by executing the oldest bid (offer) against the oldest offer (bid) which it is marketable against, at the price of the oldest quote/order. Nasdaq then will begin processing non-directed orders that are in the queue.[77]

G. UTP Exchange Participation

Under the proposal, UTP Exchanges will be able to enter orders into the SuperMontage. Orders from UTP Exchanges that offer automatic execution reciprocity to Nasdaq will receive automatic execution against Nasdaq Quoting Market Participants that take automatic executions.[78] Participating UTP Exchanges that do not offer automatic execution reciprocity to Nasdaq will have their orders delivered to the next Nasdaq Quoting Market Participant in the queue according to their choice of the Order Execution Algorithms.[79] Otherwise, UTP Exchanges will be able to use the directed[80] and non-directed order processes of SuperMontage in the same way as Nasdaq Quoting Market Participants. Also, UTP Exchanges will be able to enter multiple non-attributable quotes/orders representing agency interest. UTP Exchanges, however, will only be able to submit a single, two-sided attributable quote, and will not be able to use reserve size or QR.

As discussed above, pursuant to the Order Execution Algorithms, non-attributable agency interest of UTP Exchanges generally will be executed on parity with displayed quotes/orders (attributable and non-attributable) of market makers and ECNs.[81] The principal interest of UTP Exchanges will be last in priority under the Order Execution Algorithms, and will be executed after the system does a complete sweep of the agency interest of UTP Exchanges and the displayed and reserve size of all Nasdaq Quoting Market Participants.

H. ECN Participation

As discussed above, ECNs that are NASD members will have the choice of participating in order delivery or automatic execution. Regardless of the

method of participation, these ECNs will have full access to the SuperMontage for order entry and order delivery. Specifically, ECNs that are NASD members will be able to designate quotes/orders as attributable or non-attributable, and will be able to transmit multiple quotes/orders at the same price or at multiple prices. All ECNs will be able to use the SuperMontage's reserve size feature for quotes/orders. ECN participation in Nasdaq will continue to be governed by rule and private contract.

I. Odd-Lot Processing

The system's odd-lot processing function was substantially modified by Amendment No. 4 to the proposal. *See* Amendment No. 4, *supra* note 6.

The SuperMontage will accept and execute orders for less than one normal unit of trading (*i.e.*, odd-lot orders). The SuperMontage will provide a separate mechanism for processing and executing odd-lot orders including: (1) an "odd-lot exposure limit" for market makers; (2) an interval delay between odd-lot executions against the same market maker; and (3) an odd-lot order entry limitation of one order per second, per firm.

Odd-lot orders will be processed in a round-robin fashion against market makers with an available exposure limit and will be executed at the BBO, even if the market makers are not at the inside. A market maker can set its exposure limit, on a security-by-security basis, from 0 to 999,999 shares. The SuperMontage will not execute an odd-lot order against a market maker unless the market maker has a sufficient exposure limit to fill the odd-lot order. When a market maker's odd-lot exposure limit is reduced to zero, it will be taken out of the odd-lot rotation unless and until the market maker sets a new exposure limit. If no market maker has an odd-lot exposure limit, the SuperMontage will suspend the processing of odd-lots until an exposure limit is refreshed. Odd-lot executions will decrement the exposure limit (but not the quote/order sizes displayed in the Nasdaq Quotation Montage or NODF) by the size of the odd-lot order. To ensure continuity of price, if a mixed-lot is entered into the system, the odd-lot portion will be executed against the next market maker in the rotation at the round-lot portion price once the round-lot portion has been executed.

The odd-lot processing mechanism also will provide a maximum five-second interval delay between executions against the same market maker in the same security. A market maker will be able to adjust its interval-delay time down (*i.e.*, down to 0 - 4 seconds), so that it may receive odd-lot executions more frequently than five seconds apart. Thus, after an odd-lot has been executed against a market maker with an available exposure limit, there will be at most a five-second interval delay before the market maker will be subject to another odd-lot execution. During the five-second (or less) interval delay, the market maker could adjust its odd-lot exposure limit up or down. Finally, the system will be programmed to accept odd-lot orders at a rate no faster than one order per second from any single participant.

J. Nasdaq SmallCap

Nasdaq proposes to use the SuperMontage for all Nasdaq securities, including SmallCap securities. Nasdaq proposes to delete the current SOES rules excluding SmallCap securities from the NNMS.

K. System Roll Out

Nasdaq described its proposed system roll out in Amendment No. 5 to the proposal. *See* Amendment No. 5, *supra* note 8.

Nasdaq intends to implement the SuperMontage as soon as practicable after decimal pricing is fully implemented in Nasdaq.[84] Nasdaq plans to give market participants and vendors at least 90 days notification of changes in system specifications. At the time of such notification, market participants will be given new specifications in order to begin analyzing the system changes. Nasdaq has represented that its staff will work throughout this period with market participants to address any system and specification-related questions and issues.

At least 60 days prior to system implementation, Nasdaq plans to give participants notice of specific testing dates and of the availability of a testing environment. In addition, at least 30 days prior to system implementation, Nasdaq plans to make available a testing environment in which firms may begin testing their software and hardware (if applicable). Finally, Nasdaq plans to hold at least two full-day, mock trading sessions on a weekend. This will allow market participants to train their personnel on the new system and to participate in a real-time trading environment.

Nasdaq plans to phase-in Nasdaq securities similar to the way the SEC's Order Handling Rules were introduced. Specifically, Nasdaq intends to initially implement the system for a limited number of securities (*e.g.*, 100) representing a cross-section of Nasdaq-listed stocks. On a regular basis thereafter, Nasdaq will add 100 new stocks until the system is implemented for all Nasdaq-listed securities. Nasdaq will select a cross section of stocks to be included in each group of 100 securities to be rolled out during a particular week.

The purpose of the system roll out is to give Nasdaq and its members the opportunity to observe and gain experience with the new system, and to give Nasdaq the opportunity to make any adjustments to the system (subject to approval by the Commission), if necessary. Nasdaq intends to work closely with the Commission during the roll-out phase to ensure a smooth transition to the new system.

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IV. Summary of Comments

The Commission received 21 comment letters in response to the December 6, 1999 notice.[85] Ten commenters supported[86] and five commenters opposed[87] the proposal to establish the SuperMontage. Six commenters did not clearly state a position on the proposal.[88] Of the commenters who supported the proposal, all expressed reservations regarding certain aspects of the proposal.[89]

In response to the comment letters, the NASD and Nasdaq made several amendments to the proposal. These proposed changes were published for comment in the *Federal Register* on March 30, 2000 as Amendment No. 4.[90] The Commission received 31 comment letters from a total of 27 commenters in response to Amendment No. 4.[91] Of these 27 commenters, 20 generally supported the proposal,[92] while five opposed the proposal, including the proposed changes.[93] Two commenters expressed neither

support nor opposition to the proposal.[94] Of those commenters who expressed support for the proposal, three expressed reservations about certain aspects of the proposal.[95]

In response to these comments, the NASD and Nasdaq made additional revisions to the proposal. The proposed changes were published in the *Federal Register* as Amendment Nos. 5, 6, and 7 on August 15, 2000.[96] The Commission received 28 comment letters in response to these Amendments.[97] Twelve expressed support for the proposal,[98] while 13 continued to oppose it.[99] Three commenters supported the general concept of the SuperMontage, but expressed concerns about specific provisions contained in the proposal, or did not clearly state a position on the proposal.[100]

In response to these comments, the NASD and Nasdaq made several additional changes to the proposed rule change. The proposed changes were published in the *Federal Register* as Amendment No. 8 on November 15, 2000.[101] The Commission received 24 comment letters in response to Amendment No. 8. One commenter expressed support for the proposal,[102] while 6 continued to oppose it.[103] Eight commenters supported the general concept of the SuperMontage, but expressed concerns about specific provisions contained in the proposal.[104] Nine commenters, while objecting to certain aspects of the proposal, did not clearly state a position on the proposal as a whole.[105]

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V. Discussion

After carefully considering the comments, the Commission finds, for the reasons discussed below, that the SuperMontage proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD. In particular, the Commission finds that the proposal is consistent with the requirements of Sections 15A(b)(6), (9), and (11), and 11A(a)(1)(C) of the Act.[106] Section 15A(b)(6)[107] requires that the rules of a registered national securities association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Section 15A(b)(9) requires that the rules of an association not impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.[108] Section 15A(b)(11)[109] requires that the rules of an association be designed to produce fair and informative quotations, prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations. And finally, in Section 11A(a)(1)(C),[110] Congress found that it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure: (1) the economically efficient execution of securities transactions; (2) fair competition among brokers and dealers; (3) the availability to brokers, dealers, and investors of information with respect to quotations and transactions in securities; (4) the practicability of brokers executing investors' orders in the best market;

and (5) an opportunity for investors' orders to be executed without the participation of a dealer.

As discussed more fully below, the Commission finds that the proposed changes are in the public interest and are designed to assure the economically efficient execution of securities transactions by increasing the availability of pre-trade information in Nasdaq securities, as well as the opportunity for the orders of market makers, public customers, and order entry firms to interact. Several commenters believed that the proposal will improve the Nasdaq market by either providing more information to investors, promoting greater efficiency in executions, or increasing overall market transparency.[111] The ICI, for example, stated that "creating a system that provides investors with greater access to priced orders and allows them to execute against those orders will greatly enhance the quality of the Nasdaq market."[112] MSDW stated that the "ability to enter multiple proprietary/agency quotes/orders at multiple price levels will greatly assist market makers in managing their limit orders."[113] TRPA stated that "the SuperMontage concept furthers the goals of unifying the markets and providing a means for orders to interact with one another, while allowing for continuing innovation."[114] The Commission agrees with these commenters that there is good reason to conclude that the SuperMontage, by providing for the enhanced display of trading interest in Nasdaq securities and by expanding the availability of automatic execution, will facilitate the price discovery process and promote quote competition among Nasdaq Quoting Market Participants and UTP Exchanges, thus helping to ensure the best execution of customer orders.

In addition, by introducing features to: (1) assist market makers with the management of their quotes/orders; (2) reduce instances of double liability for market makers; and (3) encourage the entry of larger sized quotations and orders by market makers and ECNs, the proposal likely will add liquidity to the market and help assure the economically efficient execution of transactions in Nasdaq securities. The proposed changes thus should enhance the efficiency and increase the depth and liquidity of the market for Nasdaq securities, to the benefit of all investors.

A. Nasdaq Order Display Facility

The NODF will increase the availability of information about quotations by displaying the three best price levels in Nasdaq on both the bid and offer side of the market to supplement the Nasdaq Quotation Montage. Each price level will be updated and will display aggregate trading interest at that price level.

Several commenters stated this aspect of the proposal will result in more information to investors, promote greater efficiency in executions, promote liquidity, increase market transparency, and reduce market fragmentation.[115] For example, several commenters believed that the proposal will provide a better overall picture of the market's depth by enabling market participants to display (and accept) multiple levels of priced orders.[116] In addition, one commenter believed that the enhanced display of trading interest will promote investor protection by decreasing trade-throughs (*i.e.*, trades at prices worse than those available for a security) and giving market participants more options for meeting best execution, firm quote, and limit order display obligations.[117] Another commenter stated that the proposal will help improve the current state of fragmented trading in Nasdaq securities, and offer an improved execution system over SOES and SelectNet.[118] A third commenter believed that the

NODF "will offer an enhanced means for market participants to gauge trading interest at the Nasdaq inside market and prices near the inside market."[119]

Two commenters, however, questioned the need for the NODF.[120] One of these commenters believed that fragmentation was no longer a problem in the Nasdaq market.[121] Further, this commenter argued that if the NASD was concerned about the fragmentation and transparency of pre-trade information, the NASD should allow market participants to display all of their bids and offers under their MMID.[122] Another commenter argued that the NODF would create a false perception of liquidity in Nasdaq because orders below a market participant's top of book will not be attributed to the firm representing the order.[123] This commenter believed, as a result, that liquidity will appear to reside in Nasdaq, rather than with the broker/dealer that represents the liquidity in Nasdaq.[124]

One commenter also believed that the NODF was unnecessary because ECNs and market makers have created their own limit order books, and that the proposed NODF will not provide any additional capability to the market.[125] Another commenter believed that the SuperMontage proposal did not provide complete transparency because of its anonymous display and reserve size features.[126] This commenter urged the Commission to review this issue to ensure that large players do not receive an unfair trading advantage that is not available to small investors.[127] Two commenters also suggested that the NODF should display the five best price levels in Nasdaq on both the bid and offer side of the market to allow investors to better gauge the market[128] and to constrain volatility.[129] Another commenter believed that Nasdaq should display information for individual market makers and ECNs up to three price levels.[130]

The Commission finds that the NODF, as part of the SuperMontage, is consistent with Sections 15A(b)(6) and 15A(b)(11) of the Act[131] in that, among other things, it is designed to facilitate transactions in securities and to produce fair and informative quotations. Further, the Commission finds that the order aggregation characteristics of the proposed rule change are consistent with Sections 11A(a)(1)(B) and 11A(a)(1)(C) of the Act.[132] In particular, in Section 11A(a)(1)(B), Congress found that new data processing and communications techniques create the opportunity for more efficient and effective market operations.[133]

The Commission believes that the NODF has the potential to facilitate securities transactions by enhancing the display of trading interest. Currently, when Nasdaq receives a quote, it cannot discern whether that quote represents a single order or multiple orders at one price. Nasdaq Quoting Market Participants and UTP Exchanges can send Nasdaq only a single, two-sided quote. In contrast, under the proposal, Nasdaq Quoting Market Participants and UTP Exchanges generally will have the ability to transmit multiple orders at multiple price levels for display at their discretion.[134] In addition, the NODF has two other features designed to enhance the display of trading interest -- the size of displayed interest will be aggregated at the best three price levels on both sides of the market and the Summary Scan function will show the total displayed size (attributable and non-attributable) for all levels below the first three price levels. With the implementation of decimals, market participants will need to view and access greater depth. At a penny quotation increment, for example, a best offer of $20 for 100 shares may be less meaningful than a second best offer at $20.01 for 1,000 shares. As discussed in more detail

below, because the NODF is designed to enhance the display of trading interest among participants, it should facilitate trading in a decimals environment.[135] While the Commission agrees with certain commenters that display of depth beyond three levels may be necessary once the markets move to decimals, the Commission understands that Nasdaq will consider expanding the number of levels as it further develops the system.

With respect to concerns that Nasdaq should display even greater information, the Commission believes that Nasdaq's proposed NQDS Prime, which will provide on a real-time basis, all individual attributable quote and order information at the three best price levels displayed in the NODF,[136] will help to address these concerns. NQDS Prime will enhance the display of trading interest and provide market participants greater information in making order-routing decisions. The Commission believes that this will provide investors with more options since market participants will be able to use this information to access liquidity through Nasdaq or non-Nasdaq systems (such as proprietary links).

1. Non-Attributable Quotes and Other Features

Under the proposed rule change, a SIZE MMID, representing the aggregate size of the best-priced non-attributable bids or offers, will be displayed in the Nasdaq Quotation Montage along with the other MMIDs for the Nasdaq Quoting Market Participants and UTP Exchanges displaying attributable size.

The Commission received several comment letters addressing this display feature in response to the December 6, 1999 notice.[137] One commenter believed that there is a risk that non-attributable proprietary orders will be susceptible to manipulation because a market maker could post a small bid under its own MMID and post a larger sell order anonymously.[138] Another commenter argued that because Nasdaq Quoting Market Participants and UTP Exchanges can display quotes/orders anonymously under the proposed rule change, a "moral hazard" might be created.[139] The commenter expressed concern that participants with weaker credit might "hide behind unattributable quotations in times of market stress."[140] Further, this commenter noted that because the solvency of a participant's counterparty may be unknown, investor confidence could be threatened.[141] This commenter also opined that the anonymous display feature will deny viewers the opportunity to access secondary or tertiary quotations directly.[142] In addition, one commenter believed that order entry firms could use the feature to access ECNs without paying an access fee.[143]

Another commenter pointed out that the NASD has not revealed how it proposes to provide participants with transaction reports.[144] This commenter stated that the counterparty to a transaction should be disclosed at the time an order is executed, not at the end of the trade day.[145] This commenter explained that disclosure of a counterparty's identity at the time of execution is critical in order for a market participant to monitor its intraday credit risk exposure.[146]

In response to some of the issues raised by commenters, the NASD has committed to assist market participants in their efforts to manage operational and credit risk.[147] Nasdaq will affix the MMID of the sender to all directed orders, delivered non-directed orders, and delivered preferenced orders. Further, preferenced orders and non-directed orders that are executed against a market maker or other market participant that participates in the automatic execution functionality of the system will

result in an execution report immediately upon execution that identifies all of the parties to the trade. This is true if a non-directed order is executed against an attributable order or a non-attributable order.[148]

Two commenters believed that these features will allow ECNs to deny access to their quotes through SuperMontage to non-subscribing firms that do not pay their fees.[149] One of these commenters believed that "[s] anctioning the denial of quote access through SuperMontage also conflicts with [b]est [e]xecution, as a firm who has been denied access may be unable to hit the inside bid or offer."[150]

As an initial matter, the Commission notes that market makers currently can enter multiple quotes/orders by submitting a quote/order to Nasdaq and orders to multiple ECNs. Under the Commission's Order Handling Rules,[151] a market maker can place a better-priced order with an ECN anonymously without updating its quote to reflect the better-priced order, as long as the ECN displays the order in the public market. Other market participants also may submit orders to ECNs and have their orders traded on an anonymous basis. As a result, market participants trading with ECN quotes currently are subject to a certain level of uncertainty regarding their ultimate counterparty. The SuperMontage proposal merely provides market makers with the ability to display multiple quotes in Nasdaq on an attributable and non-attributable basis, which is consistent with the ability of market makers and other market participants to display orders on ECNs today.

The Commission believes that the use of non-attributable quotes (*i.e.*, SIZE MMID) in the SuperMontage has the potential to promote the display of greater market interest and encourage greater transparency in the Nasdaq market. The ability to display non-attributed market interest may encourage certain market participants to submit larger quotes/orders, particularly institutions wishing to minimize the market impact of their orders. Furthermore, the Commission believes that the NASD has minimized the concerns raised by commenters regarding the identity of those with whom they are trading by affixing the MMID of the sender on delivered orders and identifying the counterparties in execution reports. Moreover, because only Nasdaq market makers, ECNs, and UTP Exchanges can enter non-attributable orders into the system, the range of participants that are responsible for non-attributable orders on their own behalf or for an anonymous customer is limited. All Nasdaq Quoting Market Participants have established clearing arrangements and credit standings monitored by the NASD and the National Securities Clearing Corporation ("NSCC"). UTP Exchanges have similar provisions to ensure financial responsibility. Moreover, the Commission fully expects that the NASD will monitor the use of these quotes/orders with a view towards preventing manipulation. Finally, as discussed further below, the Commission notes that market participants that wish to interact with a specific market participant still will be able to direct or preference orders to Nasdaq Quoting Market Participants and UTP Exchanges, including ECNs.

2. Reserve Size

The proposed reserve size function will allow Nasdaq Quoting Market Participants to publicly display part of the full size of their order or interest, with the remainder held in reserve on a non-attributable basis.[152] The reserve size function requires Nasdaq Quoting Market Participants to initially display a minimum of 1,000 shares, and to refresh the displayed size by a minimum of 1,000 shares each time the displayed size is

decremented to zero. As originally described in the December 6, 1999 notice, reserve size would have been accessed based on time priority and status as a market maker, automatic execution ECN, or order delivery ECN.

Several commenters expressed support for the reserve size feature.[153] One commenter felt that the reserve size feature would benefit investors,[154] while another believed it would minimize the adverse market price impact associated with a larger-sized order.[155] Another commenter, however, suggested that the reserve size feature should be altered to provide market participants with incentives to display large size attributable quotations.[156]

In response to the commenter, in Amendment No. 4, the NASD added the "size/time priority" characteristic to the reserve size function to provide order execution priority for orders with the larger displayed size (after being refreshed out of reserve) over smaller displayed sizes (refreshed out of reserve size), with time priority being given to identically sized quotes.[157] In addition, the NASD revised its original Order Execution Algorithm so that it no longer distinguished between the reserve size of order delivery and automatic execution ECNs.[158] Instead, the reserve size of market makers and ECNs that did not charge a separate access fee received priority over ECNs that charged a separate access fee.

In response to the NASD's change in Amendment No. 4, one commenter questioned the Order Execution Algorithm's size/time prioritization of reserve size.[159] The commenter expressed concern that the proposed algorithm would discourage market participants from displaying orders greater than 1,000 shares.[160] Another commenter believed that size/time priority was inconsistent with the basic premise of time priority and that the first quote accessed should maintain priority regardless of size.[161]

In Amendment No. 7, the NASD again revised the reserve feature to give equal priority to quotes/orders of ECNs that charge separate access fees if they indicate that the price improvement exceeds the fee for that particular quote/order.[162] In further response to the various concerns of commenters concerning the Order Execution Algorithm, Nasdaq amended the Order Execution Algorithm for non-directed orders to allow market participants to take into account their objectives in executing their orders against the displayed and reserve size of Nasdaq Quoting Market Participants and UTP Exchanges.[163] Nasdaq now permits market participants to select one of three Order Execution Algorithms: price/time priority; price/size/time priority; and price/time priority that accounts for ECN fees.

As an initial matter, the Commission notes that all Nasdaq Quoting Market Participants can use reserve size.[164] As a result, the Commission believes that the reserve size feature should give market participants greater flexibility in handling large orders. In particular, the reserve size could prove useful to institutions that wish to minimize the market impact of their orders. Increased participation should, in turn, enhance the depth and liquidity of the market for Nasdaq securities, to the benefit of all market participants. In this regard, the Commission notes that ECNs have used reserve size features for years with considerable success.

Two requirements should ensure that market participants continue to have an incentive to display their quotes/orders. First, market participants must display a *minimum* of 1,000 shares to use the reserve size feature. Second, all displayed quotations at the same price level in the SuperMontage generally will have priority up to their displayed size over all reserve size at

the same price level. Third, market forces and competition may encourage Nasdaq Quoting Market Participants to display greater size if the price/size/time algorithm is widely used. In sum, the Commission concludes that Nasdaq's use of the reserve size feature is reasonable and could result in increased depth and liquidity in Nasdaq. The Commission, however, expects the NASD to monitor trading to ensure the proper use of the reserve size feature and compliance with the requirements applicable to the use of reserve size.

B. Order Collector Facility

Under the proposal, the OCF will: (1) transmit to Nasdaq multiple quotes/orders and quotes/orders at multiple price levels entered by Nasdaq Quoting Market Participants and UTP Exchanges;[165] (2) accept orders to access quotes/orders displayed (as either attributable or non-attributable) in both the NODF and the Nasdaq Quotation Montage; and (3) unify Nasdaq's delivery of Liability Orders to Nasdaq Quoting Market Participants and UTP Exchanges, which should minimize the potential for dual liability. Upon receipt of an order seeking to access displayed quotes/orders, the OCF will determine whether to deliver an order or an execution based on the manner in which the market participant receiving the order participates in the Nasdaq market. For example, market makers will take automatic execution,[166] and ECNs and UTP Exchanges will have the option of taking automatic execution or order delivery.[167]

As discussed further below, the Commission believes that the proposed OCF is consistent with Sections 15A(b)(6)[168] and 11A(a)(1)(C)(i) of the Act,[169] particularly with Congress' finding that it is in the public interest, and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure the economically efficient execution of securities transactions. The OCF should provide market participants with greater flexibility to reflect their buying and selling interest at various price levels by allowing them to transmit multiple attributable quotes/orders at multiple price levels, as well as non-attributable quotes/orders that conceal the identity of the responsible participant until executed.

1. Order Entry and Access

Under the proposal, order entry firms, market makers, ECNs, and UTP Exchanges will be able to access quotes/orders by submitting directed or non-directed orders up to 999,999 shares in the OCF.[170] Large orders may be submitted as non-directed orders and receive automatic execution, subject to the possible application of a 5-second interval delay between successive price levels if the order is not categorized as a Sweep Order or cannot be filled completely at the inside price plus (or minus) two price ticks.

Five commenters expressed concern about access to the system.[171] One of these commenters stated that the SuperMontage, as proposed, was too limited, and should permit all NASD members to enter non-attributable limit orders in the system.[172] One commenter specifically expressed concern that order entry firms would be excluded from receiving automatic executions for proprietary orders sent to the system.[173]

The Commission believes that the NASD has adequately addressed the commenters' concerns that access to the proposed system is too limited. First, the NASD has stated that order entry firms, as well as Nasdaq

Quoting Market Participants and UTP Exchanges, may enter either directed or non-directed orders intended for execution into the OCF. Moreover, order entry firms sending proprietary orders to the system to access market maker quotes/orders will receive automatic execution of those orders. Second, the Commission believes that it is reasonable for Nasdaq to limit the ability to *display* quotes/orders to registered market makers, ECNs, and UTP Exchanges. These participants have certain obligations under the Exchange Act, including those under the Order Handling Rules. Market makers in particular have unique obligations under NASD rules, such as the requirement to maintain continuous two-sided markets. ECNs offer efficient display and execution systems for limit orders. Limiting the ability to enter non-attributable limit orders into the system to market makers and ECNs encourages their participation in the Nasdaq market, which strengthens the Nasdaq market as a whole. Accordingly, the Commission concludes that the OCF is reasonably designed to provide order entry firms, as well as market makers, ECNs, and UTP Exchanges, with prompt access that is not unfairly discriminatory to the current inside market in Nasdaq securities.[174] By facilitating the prompt and efficient execution of orders at the best available prices in Nasdaq, the OCF should strengthen the Nasdaq market, which will benefit market participants and investors.

2. Non-Marketable Limit Orders

As originally proposed, marketable limit orders entered into the SuperMontage that became unmarketable prior to execution would have been held in the queue for 90 seconds to enable the order to retain time priority should it become marketable again. One commenter opined that this treatment of limit orders would violate the Commission's Order Handling Rules.[175]

Under Amendment No. 8, non-directed orders entered by order-entry firms must be designated as immediate or cancel orders, while orders entered by Nasdaq Quoting Market Participants and UTP Exchanges may be designated as immediate or cancel. As a result, if an order-entry firm enters a marketable limit order that becomes unmarketable after entry into the system, Nasdaq will return the order (or the unexecuted portion thereof) to the entering party.[176] If a Nasdaq Quoting Market Participant or UTP Exchange enters a marketable limit order that becomes unmarketable after entry and is not designated immediate or cancel, the system will reformat the order and display it as a quote/order on behalf of the entering participant.

The Commission believes that the NASD's amendment addresses concerns about the SuperMontage retaining undisplayed orders in the system. Further, the Commission notes that the NASD must comply with the Order Handling Rules and the dissemination of bids and offers.

C. Quote Refresh and Revised SOESed-Out-of-the-Box Procedures

Under the proposed rule change, market makers can refresh size and price using the QR function if their quotes are decremented to zero. If a market maker uses QR, but has an attributable quote/order in the system that is priced at or better than the quote/order created by QR, Nasdaq will display the better-priced or equally-priced attributable quote/order in the system. If a market maker is not using QR and the market maker has given Nasdaq multiple attributable quotes/orders, Nasdaq will display the market maker's next best-priced attributable quote/order if its displayed quote/order has been decremented to zero. In addition, if a market maker's quote is closed

for three minutes, and the market maker has failed to transmit a revised attributable quote/order, the market maker's quote will be automatically reopened at the lowest bid and highest offer currently being displayed for a normal unit of trading.

One commenter applauded the NASD's decision to reduce the time period that market makers have for updating their quotes from five to three minutes.[177] This commenter and another commenter, however, believed that the 3-minute grace period during which a quote could be closed was too long.[178] In addition, the commenter believed that the NASD's proposal to restore a quote after the three-minute grace period to the outside displayed quote/order was contrary to the NASD's policy on autoquotes reflected in NASD IM 4613.[179] Another commenter opined that there could be a large number of market makers that are not in the market as their size is decremented to zero, particularly during times of significant market volatility.[180]

The Commission believes that the QR function of the OCF, together with the reserve size refresh function, should help market makers maintain continuous, two-sided quotes and thereby facilitate market liquidity. In particular, the SuperMontage's automatic refreshing and reopening of the market maker's quote for a normal unit of trading (generally 100 shares) at the lowest bid and highest offer currently being displayed in that security should assist market makers in the management of their quotes and also ensure a market maker's continued participation in the market. Under the NASD's current rules, if a market maker fails to restore its quote in a security within five minutes after the quote is decremented to zero, then, subject to certain exceptions, that market maker is prohibited from re-entering its quote for 20 days. The current rule thus effectively eliminates the participation of market makers for 20 days (also known as being "SOESed-out-of-the-box"). In contrast, the revised procedures should help to ensure the presence of liquidity providers in the market.

The Commission believes that Nasdaq has struck an appropriate balance by eliminating the SOESed-out-of-the-box penalty while adding features to assist market makers with their quote management, and by reducing the time that a quote may be in a closed state from five minutes to three minutes. The Commission fully expects, however, that the NASD will monitor the use of the system defaults by market makers to ensure that they do not become a surrogate for meaningful market making, and that the NASD will reevaluate the penalties against market makers for failure to properly maintain two-sided quotes if there is a decline in the overall quality of market making, particularly during market volatility.

D. Order Execution Algorithms

The originally proposed Order Execution Algorithm, described in the December 6, 1999 notice, distinguished between market makers and ECNs that participated in the automatic execution functionality of the system and ECNs that participated in the order delivery functionality of the system. Market participants that received automatic executions would have been given priority in the Order Execution Algorithm.

Six commenters criticized the NASD's proposed Order Execution Algorithm.[181] Three of these commenters specifically opposed the Order Execution Algorithm's prioritization of automatic execution participants (*i.e.*, market makers and ECNs that accept automatic executions) over order delivery participants.[182]

In response, the NASD amended the Order Execution Algorithm, eliminating the distinction between automatic execution participants and order delivery participants.[183] In lieu of this distinction, the NASD proposed to give ECNs that do not charge a separate quote access fee priority over those that do.[184] After receiving comments on this proposed change,[185] the NASD again revised the Order Execution Algorithm.[186]

In Amendment No. 7, the NASD proposed that the Order Execution Algorithm would execute non-directed orders, based on time priority, against: (1) the displayed quotes/orders (attributable and non-attributable) of market makers, ECNs that do not charge a separate quote access fee to non-subscribers, ECNs that charge a separate quote access fee to non-subscribers but indicate that the price improvement offered by their quote/order exceeds the separate quote access fee, and non-attributable quotes reflecting agency interest of a UTP Exchange; (2) displayed interest of ECNs that charge a separate quote access fee and do not indicate that the price improvement offered by their quote/order exceeds the separate quote access fee; (3) reserve size of market makers, ECNs that do not charge a separate quote access fee, and ECNs that indicate that the price improvement for their quote/order is in excess of their quote access fee (in size/time priority); (4) reserve size of ECNs that charge a separate quote access fee and do not indicate that the price improvement offered by the specific quote/order exceeds the separate quote access fee (in size/time priority); and (5) principal quotes of UTP Exchanges.[187]

In response to these changes, certain commenters again expressed objections to the Order Execution Algorithm.[188] Four commenters suggested that the Nasdaq system should be premised on strict price/time priority.[189] Another commenter suggested that the NASD replace the Order Execution Algorithm with a purely directed system, similar to SelectNet.[190] One commenter believed that access fees should not affect the determination of the BBO.[191]

In response to these commenters, in Amendment No. 8,[192] the NASD amended the proposal to give market participants that enter non-directed orders several options as to how their orders will interact with quotes/orders in Nasdaq: price/time; price/size/time; price/time that accounts for ECN access fees; and preferencing at the best price.[193] The SuperMontage will be programmed to default to the price/time priority algorithm for non-directed, non-preferenced orders. With all three algorithms for non-directed, non-preferenced orders, the system will make an exception for orders entered by a Nasdaq Quoting Market Participant when that Nasdaq Quoting Market Participant is at the inside market. [194]

One commenter supported the NASD's revision of the system's algorithms stating that generally "market participants are better off when they can make informed choices."[195] Another commenter also supported the NASD's elimination of the *per se* treatment of ECN order access fees.[196]

However, three commenters stated that giving participants a choice of algorithms was an unacceptable compromise because participants still would be offered an algorithm that discriminated against ECN orders.[197] Specifically, one commenter believed that it would be market makers, not investors, making this election, and that marker makers would put investors' orders entered on ECNs behind market makers to avoid interacting with ECNs.[198] Another commenter believed that the default algorithm, in part, provided "a level of institutional and regulatory

legitimacy to ECN access fees, even though the vast majority of market participants consider those fees invalid and have never had the opportunity to debate or challenge them."[199] Two commenters also believed that investors' orders should be executed against first.[200] In addition, four commenters generally supported executions based on strict price/time priority.[201]

Seven commenters also objected to the addition of the price/size/time algorithm proposed in Amendment No. 8.[202] Two of these commenters stated that granting size priority ahead of time priority would negate the incentive for price improvement.[203] In addition, one of the commenters argued that the price/size/time algorithm would offer little, if any, benefit because, under the other two algorithms, participants would still have the ability to sweep through all orders at a given price level.[204] Further, this commenter noted that participants could utilize directed orders to send an order to a participant displaying greater size.[205] Another commenter believed that the price/size/time algorithm would handicap small retail traders that rely on limit orders to avoid the uncertain execution risk of market orders sold to wholesale trading interests.[206] One commenter stated that the price/size/time algorithm was an unacceptable effort to attract larger orders.[207]

As discussed in more detail below, the Commission finds that the Order Execution Algorithms are consistent with Section 15A(b)(6) of the Act[208] because they do not unfairly discriminate against customers, issuers, brokers or dealers. The Commission also finds that the algorithms are consistent with Section 11A of the Act[209] in that they promote the creation of a national market system by helping to create the opportunity for more efficient and effective markets, maintain fair and orderly markets, and assure the economically efficient execution of securities transactions. Although none of the algorithms maintains pure price/time priority, they afford price/time priority to a wider range of orders than is currently available in Nasdaq.

The Commission believes that the NASD's decision to retain the algorithm that executes/delivers orders on a price/time priority basis, taking into account ECN quote access fees, as one of the algorithms offered, is acceptable. The Commission does not believe that the proposed algorithm unfairly discriminates against ECNs, particularly in light of the fact that participants may choose either of two other algorithms that do not consider ECN fees.[210] The choice rests with the participant entering an order. By offering three algorithms, participants may interact with the SuperMontage based on their preferences and priorities. For example, at least one ECN commenter argued prior to Amendment No. 8 that market participants frequently place greater importance on price improvement offered by ECNs than on the access fees they charge, and therefore, they prefer to interact with ECNs.[211] Thus, presumably, these market participants would use the SuperMontage's default algorithm based on price/time priority to interact with ECNs that offer price improvement. For the same reason, the Commission believes that the default algorithm is acceptable. Those market participants that elect to take into account ECN fees may do so under the price/time algorithm that takes into account ECN fees.

The Commission also concludes that the NASD's algorithm based on price/size/time priority is consistent with the statute. This algorithm will assist participants in quickly assessing liquidity in a dynamic trading environment, while rewarding liquidity providers, particularly in a decimals

environment where liquidity may be spread over a greater number of trading increments. The Commission acknowledges concerns raised by commenters that the choice of algorithms lessens the importance of time priority, and thus may provide less incentive to aggressively enter better-priced quotes. However, as stated above, the three algorithms proposed by the NASD afford greater price/time priority than currently exists in the market.

The Commission notes that today most orders in Nasdaq securities are executed directly between Nasdaq participants, not using Nasdaq systems. No price/time priority rules apply to this trading, other than a market maker's duty to protect its customer limit orders before trading as principal. While price priority is generally honored as a market principle in executing orders outside of Nasdaq's systems, time priority is not accorded to quotes in this trading. Even after SuperMontage is implemented, many orders probably will be executed outside of SuperMontage free from time priorities.

The Commission does not believe that entering orders into the SuperMontage should be mandated. Therefore, requiring time priority within SuperMontage runs the risk of reducing market participants' willingness to enter orders into SuperMontage, undermining its effectiveness. For this reason, the Commission believes that providing the choice of a price/size/time priority algorithm is a statutorily-permissible balance between encouraging liquidity, accommodating the preferences of market participants, and maintaining time priority. Furthermore, while this algorithm may reduce the incentive to be the first with the better price, it may encourage a Nasdaq Quoting Market Participant to display greater size. By providing this choice of algorithms, SuperMontage will allow broker/dealers to manage their orders in SuperMontage to obtain the best execution as they would in the dealer market where time priority does not apply, while still increasing order interaction within SuperMontage. The Commission also believes that the choice of algorithms could promote greater competition and innovation among market centers and market participants.

1. Matching Against a Participant's Own Quote/Order at the BBO

All three Order Execution Algorithms first match orders entered by a Nasdaq Quoting Market Participant against its own quote/order on the other side of the market if the Nasdaq Quoting Market Participant is at the BBO. Several commenters expressed support for this internalization feature of the Order Execution Algorithm.[212] The commenters believed that matching a market participant's order against the market participant's quote/order if the market participant is at the BBO will enable market participants to better manage their order flow while at the same time providing customers with best execution.[213] Without the internalization feature, one commenter wrote, "the [proposed Nasdaq] system begins to look like a central limit order book ["CLOB"]," which the commenter opposed.[214]

Five commenters, however, questioned or opposed the proposal's internal matching provision.[215] One of these commenters opined that the internalization of orders could impede access to liquidity and price discovery for market participants, especially if a significant amount of a particular security's daily volume is internalized.[216] Two commenters stated that market makers receiving directed orders should be under an affirmative obligation to seek price improvement.[217] One of the two commenters also stated that the internalization function provided a disincentive for market

makers to price improve.[218] This commenter suggested that the internalization function, combined with the inferior priority of ECNs that charge separate access fees, would reduce market maker incentives to better the national BBO.[219] Another commenter expressed strong opposition to the internalization function of the SuperMontage, arguing that it was an example of the proposal's bias towards market maker interests.[220]

The Commission recognizes that, today, trading interest in the Nasdaq market is largely divided among different market centers. It is primarily a dealer market, in which multiple market makers compete for order flow based on a variety of factors, including internalization and payment for order flow arrangements.[221] Under these arrangements, orders are routed to a particular market maker that has an opportunity to execute the orders as principal without facing significant competition from investors or other dealers who may wish to interact with the directed order flow. Thus, presently, market makers internalize order flow without ever providing access to any other market participants publicly displaying their quotes/orders.[222] It is unlikely that market makers will enter customer market orders into SuperMontage rather than simply internalizing them directly. Still, the internal matching function attempts to encourage market makers to enter these orders into SuperMontage where superior quotes would have some chance of interacting with them. The Commission believes that the SuperMontage's internalization feature is a reasonable attempt to encourage Nasdaq Quoting Market Participants to include their customer orders in a system that will provide greater transparency and accessibility to other participants, and could lead to a more transparent and seamless integration of internalizing market makers with the rest of the marketplace.

The Commission reiterates, however, that its approval of this aspect of the proposal is based on the structure of the existing dealer market and the voluntary nature of the SuperMontage. The Commission also reiterates its long-standing position that, while a broker does not necessarily violate its duty of best execution by internalizing its agency orders, the duty also is not necessarily satisfied by routing orders to a market center that merely guarantees an execution at the national BBO without taking into account the possibility of price improvement.[223]

2. Preferenced Orders

Prior to Amendment No. 8, one commenter recommended bringing back preferencing, arguing that it would separate quotation collection and accessing technologies, because "market participants would be able to respond to quotations in the market place without placing their orders in the SuperMontage ECN order book. Accordingly, participation in the SuperMontage could then more appropriately be said to be voluntary."[224]

In response to the commenter, the NASD amended the proposal to include a new class of order called a preferenced order.[225] The NASD proposed two possible approaches to preferenced orders: preferenced orders with no price restrictions (Alternative A) and preferenced orders only at the best price (Alternative B).

Two commenters supported Alternative A, because it would provide flexibility.[226] Another commenter, who did not specifically support Alternative A, opposed the adoption of Alternative B because it would

constitute a first step in transforming the SuperMontage into a CLOB.[227] However, other commenters disagreed, claiming, for example, that allowing market makers to preference orders away from the BBO would give them the ability to trade with each other and ignore better-priced quotes/orders offered by other participants.[228] The NASD responded by withdrawing Alternative A.[229]

Under the current proposal, a market participant entering a preferenced order must designate by MMID the Nasdaq Quoting Market Participant or UTP Exchange against which the order is to be executed or delivered. The preferenced order will be entered into the non-directed order process, and will be considered a Liability Order. Preferenced orders will be processed in the same queue as non-directed orders. Additionally, like non-directed orders, a preferenced order will be delivered as an order to an ECN or UTP Exchange that does not participate in the automatic execution functionality of the system, or will be delivered as an execution against market makers as well as ECNs or UTP Exchanges that choose to accept automatic executions.

When a preferenced order is next to be executed within the non-directed order queue, the preferenced order will be executed (or delivered for execution) against the preferenced Nasdaq Quoting Market Participant or UTP Exchange to which the order is being directed only if the Nasdaq Quoting Market Participant or UTP exchange is at the BBO up to the displayed and reserve size. If the preferenced Nasdaq Quoting Market Participant or UTP Exchange is not at the BBO when the preferenced order is next to be executed or delivered, the preferenced order will be returned to the entering participant. Thus, under this approach, preferenced orders only will be executed at the BBO, and only if the preferenced Nasdaq Quoting Market Participant or UTP Exchange is quoting at the BBO at the time of execution or delivery.

Several commenters objected to the addition of preferenced orders.[230] Two commenters believed that market makers will use preferenced orders to avoid order routing priorities (such as price/time) in Nasdaq.[231] Two commenters believed that because preferenced orders will allow market participants to trade around price-setting orders, broker/dealers will be able to enter into payment for order flow agreements more easily.[232] Another commenter also argued that because preferenced orders will diminish price/time priority, fewer investors will enter limit orders into the SuperMontage, thus decreasing liquidity in the system.[233]

The Commission notes, first, that the preferencing feature allows any market participant to designate those market participants with whom it wishes to transact on a Liability Order basis,[234] while ensuring that its customers receive executions at the BBO. Second, preferenced orders allow ECNs, UTP Exchanges, and market makers to accept Liability Orders designated for them without incurring double liability since these orders will be processed in the non-directed order queue. This may encourage market participants to display larger size quotations and thereby increase liquidity in the market. Third, the Commission notes that this is just one of the delivery options available to market participants and that market participants also may send directed orders, non-directed non-preferenced orders, and orders outside the SuperMontage (via private links) using, in part, data from NQDS Prime.

The Commission also notes that preferenced orders will not duplicate the features offered by directed orders. These orders differ significantly.

Directed orders will always be delivered for a response (*e.g.*, accept or decline), as opposed to an automatic execution, and directed orders will not decrement a quote. Preferenced orders, on the other hand, will be Liability Orders processed in time sequence (like non-directed orders), will be delivered to the quote/order, or will be automatically executed against the quote/order of a market participant, and will decrement the size of a quote/order. Based on these differences, the Commission believes that directed orders and preferenced orders will provide participants with distinct features from which they may choose, depending on their needs.

It is highly unlikely that orders subject to payment for order flow will be preferenced through SuperMontage rather than routed directly to market makers. Still, those orders that are preferenced will not freely interact with limit orders and quotes in SuperMontage, and so will not encourage aggressive quoting in SuperMontage, as noted by commenters. But, here again, SuperMontage will be a voluntary system operating in a market with no general time priority. Orders that might be preferenced within SuperMontage could also be routed directly to market makers and ECNs outside of SuperMontage. Nasdaq evidently determined that preferenced orders otherwise would simply be executed outside of SuperMontage, and chose to accommodate them within SuperMontage.

The proposal now requires the recipient of the preferenced order to be quoting at the BBO, which encourages Nasdaq Quoting Market Participants or UTP Exchanges to at least quote as well as the best quote to receive these orders. Thus, the requirement encourages better quotes from these participants.

In all, while the Commission recognizes that preferenced orders do not create as strong incentives to quote aggressively in SuperMontage as would strict time priority, there is substantial doubt whether these orders would be entered in SuperMontage at all without the preferencing feature. And, by preferencing these orders through SuperMontage, order entry firms can provide special handling to difficult orders while encouraging recipients to maintain competitive quotes. The Commission's approval of this aspect of the Order Execution Algorithms is predicated on the context of the existing dealer market.

3. ECNs

a. Order Execution Algorithms

In Amendment No. 4, the NASD amended the original Order Execution Algorithm to give market makers[235] and ECNs that do not charge separate quote access fees priority over ECNs that charge separate access fees.[236] The NASD stated that this prioritization was consistent with the practice of many market participants to route their orders to market makers that do not charge a fee before routing to ECNs that do, in order to ensure that they incur the lowest possible trading costs consistent with best execution principles.[237]

Six commenters addressed this change to the proposal.[238] Two commenters agreed with the NASD that it is appropriate to give the orders of ECNs that do not charge fees priority over those that do because the ECNs that charge fees provide an inferior execution price.[239] One of these commenters stated that, "by definition, ECNs that are charging access fees should lose their standing as their order is effectively an inferior price."[240] An earlier commenter on the original proposal also suggested that any

access fees charged by ECNs should be reflected in their displayed quote so that other market participants could make informed order routing and best execution decisions.[241]

Four commenters, however, objected to the priority rules and disagreed with the NASD's rationale.[242] Instinet, for example, argued that ECNs frequently offer a better price than market makers at the national BBO, even after access fees have been deducted from the execution price.[243] Instinet believed that the Order Execution Algorithm would result in an anti-competitive trading environment because it was based on the false assumption that ECNs that charge fees provide inferior executions, and because the Nasdaq system has no mechanism to identify an ECN's true price. Instinet also stated that market participants appear to place greater importance on price improvement opportunities than on ECN access fees. In addition, Instinet asserted that the amended Order Execution Algorithm failed to take into account the general negative impact on best execution and the diminished opportunities for price improvement that would result from giving ECNs that charge order access fees inferior priority. Similarly, Island argued that it was inconsistent for the NASD to claim, on one hand, that "the de minimus access fee that ECNs typically charge warrants consideration under the principles of best execution," while on the other hand refusing to acknowledge the price improvement, however small, that ECNs generate for investors by providing a rounding indicator of ECN quotations that better the inside market.[244]

In response, the NASD revised the Order Execution Algorithm to allow an ECN to offset the price improvement for the particular quote/order against the access fee for purposes of determining price priority. Where price improvement exceeds the fee charged to non-subscribers, the ECN quote would be on parity with the quotes/orders of market markets, ECNs that do not charge a separate fee, and the non-attributable agency quotes/orders of UTP Exchanges.[245] The NASD also represented that if, in the decimals environment, ECNs change the manner in which they charge fees and develop the capability to reflect access fees in their published quotes, the NASD would give these ECNs the same priority for non-directed orders as market maker quotes/orders and non-attributable agency quotes/orders of UTP Exchanges.[246] Further, the NASD committed to re-examine the Order Execution Algorithm if, after decimals are implemented, Nasdaq quotation increments are finer than one penny. Should this occur, the NASD would determine whether it is prudent and feasible to rank orders based on quotation increments of less than one penny.[247]

Several commenters expressed objections to Amendment No. 7 as it pertained to ECN fees.[248] Specifically, one commenter stated that the algorithm was based on the assumption that access fees affect a dealer's decision to hit a bid or take an offer.[249] This commenter pointed out that dealer bids often "remain at a specific price while a market maker sells stock at the same price in the ECNs, accepting their fee. The dealers have the opportunity to trade net but choose the liquidity and anonymity of the ECNs instead in exchange for the fee."[250]

Various commenters suggested that the Order Execution Algorithm was unfairly discriminatory. For instance, one commenter stated that the revised algorithm was discriminatory since the only fees included were ECN fees.[251] The commenter believed that the need for this treatment was unsubstantiated.[252] Another commenter objected to the manner in which the NASD proposed to determine whether an ECN offered price

improvement net of its access fee, and therefore could be treated on par with market makers.[253] This commenter stated that the proposed algorithm will use an ECN's net price when the ECN's gross price is equivalent to, and the net price is inferior to, other orders displayed in Nasdaq, but will use an ECN's gross price when the gross price is equivalent to, and the net price is superior to, all other orders in Nasdaq.[254]

Two commenters suggested that the proposed amendment would negatively affect price competition and result in wider spreads. In particular, the commenters noted that market makers would have no incentive to provide price improvement at the national BBO.[255] One commenter stated that ECNs should be given top priority if their orders, when factoring in price improvement, represent the best bid or offer, and that all limit orders should be processed in strict price/time priority without regard to ECN access fees.[256] Another commenter also objected to providing ECNs with execution parity only when their price improvement exceeds their fee.[257]

One commenter suggested that the proposal would "unwind the SEC's order-handling rules by pushing a significant majority of ECNs to the back of Nasdaq's priority queues despite a record of publishing the market's best prices with far greater frequency than Nasdaq market makers."[258] Another commenter stated that the proposal to have ECNs report price improvement within their quote is "unrealistic" in a "dynamic order environment."[259] This commenter also believed that if Nasdaq "is to become a for-profit central execution center, it is inappropriate for Nasdaq to impose any methodology of prioritization within the system on factors other than displayed price."[260]

One commenter also questioned the NASD's rationale for the need of the algorithm.[261] The commenter opined that firms, not investors, pay the access fees charged by ECNs and, therefore, it is not true that individuals who execute a particular trade on an ECN that charges an access fee automatically receive a clearly inferior price.[262] In addition, the commenter believed that, as a result of rounding, even in a decimals environment, investors may be denied access to a better price.[263]

In addition, four commenters believed that the algorithm unfairly penalized order delivery ECNs that enter an order at one quantity and then increase size to add an additional quantity to reflect one or more customer limit orders.[264] Specifically, two of these commenters believed that ECNs were treated unfairly under the algorithm if they either reduced the order size or placed or changed an order on the other side of the market for the security.[265] The commenters believed that, under the current algorithm, the changes would take away a market maker's or ECN's established time priority.[266]

In response to commenters, the NASD amended the Order Execution Algorithm to provide three alternative Order Execution Algorithms for accessing quotes/orders in the SuperMontage. These alternatives are based on price/time priority, price/time priority considering quote access fees, and price/size/time priority. Further, the NASD amended the proposal to give parity to ECNs that charge quote access fees when the price improvement on a particular quote/order at least equals the fee under the price/time priority option that takes ECN fees into account. In addition, the NASD responded to commenters by protecting the time priority of Nasdaq Quoting Market Participants that change their displayed trading interest by

increasing displayed size.[267] As amended, the system will maintain the original time stamp for the original quantity and assign a separate time stamp for the augmentation, thus protecting the time priority of the originally entered quantity. Subsequent non-execution decreases in size will be deducted from individually stamped components in reverse time priority (*i.e.*, the last entered size component will be exhausted first).

One commenter complained that the revised Order Execution Algorithms fail to provide a real choice, since market makers will "inevitably choose the algorithm that allows them to avoid interacting with investor orders on ECNs as ECNs charge access fees."[268] Another commenter questioned the NASD's justification for taking into account ECN fees under the theory of "best execution."[269] This commenter believed that the Commission's approval of this theory "suggests that brokers must now consider market access fees charged to brokers in connection with their order routing decisions[,]" including payment for order flow.[270] Further, this commenter noted that the algorithm fails to "give greater priority to ECN orders that offer net' price improvement (after taking into account access fees) over other orders displayed at the same price . . . . and fails to distinguish between ECNs that charge different access fees."[271] Five commenters also believed that the algorithms fail to protect the standing of investor orders displayed on Nasdaq through ECNs.[272]

The Commission concludes that the Order Execution Algorithms and time priority protection for size increases are consistent with Section 15A(b)(6) of the Act[273] in that they remove impediments to and perfect the mechanism of a free and open market. These alternatives will give market participants greater flexibility in determining how their orders will be executed based on individual preferences and priorities and should provide broker/dealers with greater opportunities to take into account known fees and possible price improvement in choosing how to obtain the best execution for an order. If ECNs in fact offer better prices than the quote, even after taking into account their fees, then order entry firms may choose the algorithm that ignores ECN fees, or preference them directly. If ECN fees predominate over their price improvement, order entry firms likely will choose the algorithm that takes ECN fees into account. This is especially true given that the orders most likely to be routed through SuperMontage will be on behalf of the market makers themselves or institutional or sophisticated traders that can well judge whether ECN price improvement is likely to exceed ECN fees. In addition, the Commission believes that the alternative Order Execution Algorithms will provide an incentive for Nasdaq Quoting Market Participants and UTP Exchanges to display greater size and to provide price improvement to attract greater order flow under each of the possible execution alternatives.

With respect to the price/time algorithm that takes ECN fees into account, the Commission finds that it is reasonable for Nasdaq to give priority to the interest of market makers and ECNs that do not charge fees over the interest of ECNs that charge separate access fees because the quotes/orders of non-charging market makers and ECNs are equivalent at the displayed price. The quote/order of an ECN that charges a separate fee, on the other hand, typically is not comparable to the quote/order of a market maker or a non-charging ECN because it may actually result in an inferior execution price after the fee is added. In other words, when a broker-dealer accesses a market maker quote, the broker-dealer knows that it will pay exactly the amount displayed because market makers do not charge fees in addition to their quotes.[274] If a broker-dealer accesses a quote/order of an ECN that charges a separate fee, however, the broker-

dealer may be charged a fee of up to 1.5 cents per share in addition to the quoted price, which may be passed along to its customer. This per-share fee may add significantly to the costs of trading with that ECN. The price/time algorithm that takes ECN access fees into account is a reasonable attempt to allow market participants to access the quote of an entity that does not charge fees before directing their orders to an ECN that charges fees.[275]

The Commission notes, however, that today some ECNs allow finer quoting increments than Nasdaq and therefore, on occasion, may offer internal prices that are better than the prices displayed in Nasdaq, notwithstanding their fee.[276] However, until such time as SuperMontage uses quoting increments that are small enough to reflect all potential ECN fees and price improvement alternatives, it is not possible to reflect the actual net price in the quote. Thus, it is necessary for a market participant to consider *probabilities* in evaluating an ECN's quote. If the ECN charges a fee, that fee is a *certainty* in each trade to be weighed against a *possibility* of offsetting price improvement. It is reasonable for the NASD to take the certainty, but not the possibility, into account by providing an algorithm that reflects ECN fees.

Furthermore, within that algorithm, the NASD also recognizes that it is possible for an ECN's real price to be at least as good as the price displayed in Nasdaq even after its fee has been subtracted, if the price improvement offered by the ECN's internal price (as opposed to its rounded displayed price on Nasdaq) is equal to or greater than its fee. As described above, the NASD has amended the algorithm to allow a fee charging ECN to indicate that the price improvement equals or exceeds the fee for a particular quote/order. Those quotes/orders will be given the same priority as the quotes/orders of market makers and ECNs that do not charge separate quote access fees. As a result of this change, the Commission believes that the price/time algorithm that accounts for ECN fees does not discriminate unfairly against any Nasdaq market participant.[277] The algorithm treats quotes/orders that are comparable equally; only those quotes/orders that have a separate fee that exceeds the price improvement will have lower priority within the system (with the exception of UTP Exchange principal quotes, which are discussed below).

In addition, the NASD has committed to work with ECNs to develop the capability to reflect access fees in their published quotes. If fees are reflected in the quote, they will be ranked equally with those quotes/orders without fees based on price. For example, if ECN1 represents a quote/order to buy at $20.00, and charges a fee of $.01 per share, it would enter a bid of $19.99, which would be ranked in time priority with other bids of $19.99 entered by market makers, ECNs that do not charge a separate fee, and agency interest of UTP Exchanges.

The Commission notes that while quotes/orders generally will be comparable if fees are displayed in the quote, an ECN quote, on occasion, still may not reflect the true ECN price because the quote will have to be rounded if the fee combined with the quote is not at a whole penny increment.[278] However, the NASD has represented that it will re-examine the algorithm if, after decimals are implemented, quotations are in increments smaller than one penny. Should this occur, the NASD will determine whether it is prudent and feasible to rank orders based on quotation increments of less than one penny.[279]

For these reasons, the Commission finds that the price/time algorithm

taking ECN fees into account is consistent with Section 15A(b)(6) of the Act,[280] which requires that the rules of the association not be designed to permit unfair discrimination between brokers or dealers. For the same reasons, the Commission believes that it is appropriate for the reserve size of non-charging ECNs to have priority over the reserve size of ECNs that charge a separate fee.

b. Time Restrictions on the Order Delivery Feature

Under the original proposal, if a quote/order was routed to an order delivery ECN and the ECN failed to respond within five seconds of order delivery,[281] Nasdaq would immediately route the quote/order to the next Nasdaq Quoting Market Participant or UTP Exchange in the queue.

Two commenters argued that this aspect of the proposal would expose ECNs to significant financial risk because, in the event of Nasdaq system problems, ECNs might not be able to confirm the execution of a trade before Nasdaq automatically re-routed the order to the next Nasdaq Quoting Market Participant in the queue, and in turn would be required to assume the risk of filling a customer's trade.[282] One commenter recommended that the NASD give ECNs at least ten seconds to respond to incoming orders.[283] Another commenter opined that the NASD should not be able to "[d]eclare itself non-liable for errors and losses caused by Nasdaq technology failures . . . that can shift business risk to market participants. . . ."[284] To avoid punishing ECNs when the failure is Nasdaq's, one commenter proposed canceling orders if it is clear from the ECN's response that the time elapsed between the ECN's actual receipt and response exceeds a mandated minimum.[285]

In response to these comments, the NASD altered its approach to monitoring order-delivery ECN responsiveness. First, in Amendment No. 8, Nasdaq established a 30-second (as opposed to 7-second) maximum time period for an ECN to respond to any given order.[286] That is, if an ECN fails to respond within 30 seconds of the time a particular order is dispatched from the Nasdaq system to the ECN, Nasdaq will withdraw the order and "zero out" the affected side of the unresponsive ECN's quote until the ECN transmits a revised attributable quote/order.

Second, the NASD proposed a shorter uniform turn-around time of a maximum of 5 seconds. The purpose is to establish a general standard (as opposed to an order-by-order standard) that measures whether an ECN is providing an automated response in a time period that ensures market quality. If an ECN regularly fails to meet the five-second response time over a period of orders, Nasdaq will place that ECN's quote in a closed-quote state. The closed-quote state will be lifted when the ECN can certify that it can meet the five-second response time requirement.

One commenter believed that the 30-second maximum response time was reasonable and balances the competing interests of avoiding dual liability and providing an efficient trading system.[287] However, one commenter objected to the 30-second response time.[288] This commenter believed that 30seconds was too long in today's volatile, fast-paced market. Another commenter, however, expressed significant reservations about the 5-second response time standard for ECNs.[289] The commenter questioned how a determination would be made that an ECN "regularly" failed to meet the 5-second response time over a period of orders. The commenter recommended that a neutral body, such as the Commission, make this

determination using objective criteria.

The Commission believes that the NASD has responded reasonably to the concerns of the commenters that systems delays may expose them to an unacceptable degree of risk by incorporating several suggestions made by commenters, such as increasing the ECN response time and incorporating a second 5-second measurement based on an ECN's actual receipt time. While the Commission understands the concerns raised by one commenter regarding the 5-second response time measurement, the Commission notes that ECNs are required to provide an immediate automated response to SelectNet messages, and, in Nasdaq's experience, ECNs generally respond in far less than 5 seconds to orders presented to their quotes.[290] Therefore, the Commission believes that this is a reasonable time in which to expect ECNs to respond to orders on a regular basis. In addition, an earlier ECN commenter on the proposal, prior to Amendment No. 8, stated that a 5-second response time for order delivery ECNs should be more than adequate under normal circumstances.[291] Further, the Commission believes that a certain level of discretion in determining whether an ECN regularly meets this standard is necessary to maintain a flexible standard that can accommodate delays that may result from a variety of circumstances. Also, the Commission notes that Nasdaq will lift the closed-quote state of an ECN failing this standard when the ECN (not Nasdaq) certifies that it can meet the 5-second standard.

The Commission believes that the 5-second parameter should ensure that overall response times remain prompt, while still accommodating order delivery ECNs on individual orders with a 30-second response time. The Commission believes that the provisions made by the NASD to permit ECNs to control the risk of errors are reasonable and ECNs should be able to protect themselves adequately under normal operating conditions. The Commission expects, however, that during the implementation period the NASD will carefully monitor its systems to determine whether the 30-second and 5-second response times should be modified.

c. ECN's Automatic Execution Function

Under the proposal, ECNs will have the option to receive automatic executions or to receive delivered orders to which they will respond. Regardless of the method of participation, ECNs will have full access to the SuperMontage for order entry and order delivery. The SuperMontage also will have a "request a cancel" feature.[292] For example, under this proposal, if an internal subscriber of an ECN that accepts automatic executions wants to access an order in the ECN that also is being displayed in Nasdaq, the ECN could request a cancel before effecting the internal match. If the request is declined because the order already is executed in Nasdaq, the ECN could decline its internal customer's order to avoid dual liability.[293] Alternatively, the ECN could choose to take only order delivery.

Three commenters believed that ECNs should be required to participate in the automatic execution functionality instead of having an option to participate as order delivery ECNs.[294] Two of these commenters believed that the "request a cancel" functionality would minimize the potential of double executions against ECNs, and eliminate any valid reason for such a distinction between market makers and ECNs.[295] One of these commenters believed that ECNs, with certain modifications, could operate within their current business models in an automatic execution environment.[296] The commenter believed that automatic executions are essential to ensure that market participants meet their firm quote rule obligations.[297] The

commenter also suggested that if certain market participants accepted order delivery while market makers were required to participate with automatic executions, market makers would have to develop dual systems.[298]

Two commenters opined that automatic execution ECNs could be exposed to dual liability if Nasdaq execution messages arrived after matches were executed within the ECN.[299] Another commenter stated that the "request a cancel" function would cause significant execution delays thereby undermining the competitiveness of ECNs by eliminating one of the principal benefits offered by agency brokers - speed of execution.[300]

The Commission agrees with the NASD's position that it is necessary to accommodate the different trading models of all participants in the SuperMontage. In order to accommodate ECNs, the NASD has chosen to provide them an alternative to automatic execution: order delivery. The Commission believes that given the different business models of ECNs, it is not inconsistent with the statute to provide them with this alternative to automatic execution.

With regard to the commenters' concerns that ECNs may be subject to dual liability under automated execution, the Commission notes that ECNs may limit their risk of dual liability by not accepting automatic executions. Further, even if ECNs choose to accept automatic executions, their risk of dual liability may be limited by the "request a cancel" function and their ability to receive directed orders.[301] As a result, the Commission believes that ECNs have sufficient alternatives for limiting their exposure to dual liability.

4. UTP Exchange Priority

In response to commenters, the NASD amended the proposal to allow UTP Exchanges to receive automatic executions for their orders as long as they provide reciprocal automatic executions for orders sent to them from Nasdaq. Further, the NASD amended the proposal to allow UTP Exchanges to display agency interest on a non-attributable basis and have that interest receive parity with quotes/orders of Nasdaq Quoting Market Participants.[302] However, under the amended Order Execution Algorithms, the principal interest of UTP Exchanges will still be lower in priority than the quote/orders of Nasdaq Quoting Market Participants.

One commenter argued that it would be unfair and "grossly anticompetitive to give the principal interest of the UTP Exchange last priority at a given price level."[303] Another commenter stated that the SuperMontage will "severely curtail the ability of other market centers to trade Nasdaq-listed securities."[304] Two commenters believed that the SuperMontage imposes burdens on competition by not permitting attributable UTP agency orders and by placing UTP principal orders last in the queue.[305] One of these commenters also questioned the treatment of orders from UTP Exchanges that elect to receive orders rather than executions and the applicability of the Firm Quote Rule to such orders.[306]

Two commenters objected to the proposal's requirement that UTP Exchanges may only submit non-attributable orders, and thus depriving them of credit for the liquidity provided to Nasdaq.[307] One of these commenters also noted that the execution of non-attributable UTP Exchange orders in SuperMontage will deny UTP Exchanges revenue from

the sale of quotation and last sale data generated by these orders.[308]

Two commenters argued that UTP Exchanges must be treated on par with NASD members regardless of whether such Exchanges submit agency or proprietary orders.[309] One of these commenters believed that the algorithms, as proposed in Amendment No. 8, will place UTP Exchanges' proprietary quotes below inferior ECN quotes.[310] The other commenter called the NASD's proposal to give the proprietary quotes of UTP Exchanges the lowest priority in the algorithms "a bold attempt to protect Nasdaq market makers from competition," and that this treatment is not consistent with the fair competition requirement of the Act.[311] Lastly, these two commenters argued that all participants in the SuperMontage must be treated equally in order for Nasdaq to fulfill its dual responsibilities as a securities market and as an exclusive SIP.[312]

The Commission believes that it is reasonable to rank principal quotes/orders of UTP Exchanges after the quotes/orders of Nasdaq Quoting Market Participants in the SuperMontage's execution algorithms because UTP Exchanges compete with Nasdaq for order flow. Under the current UTP Plan, Nasdaq serves as the processor for quotes and trade reports in Nasdaq securities, and in this capacity UTP data is given equal treatment. However, neither the UTP Plan nor Nasdaq's SIP role requires Nasdaq to imbed competing exchanges in its trading system. Moreover, it is reasonable for Nasdaq to first conduct a complete sweep of Nasdaq Quoting Market Participants' interest before matching an order against the principal interest of another competing exchange. This practice is consistent with the practice of certain exchanges, which first probe their own markets before directing an order to another exchange. Indeed, the Intermarket Trading System ("ITS") Plan requires such a probe.[313] The Commission notes that the SuperMontage has provided that a UTP Exchange's non-attributable agency interest will receive priority on parity with market makers and ECNs. The Commission believes that the superior execution priority of non-attributable UTP Exchange agency interest over attributable UTP Exchange principal interest helps to protect agency orders and to increase order interaction in the markets.[314]

The Commission recognizes the concern raised by commenters that, because UTP agency orders are not attributed to the UTP Exchange, the liquidity contributed by the UTP Exchange will not be displayed and acknowledged. However, the Commission believes that the SuperMontage should not be required to promote and provide attribution for the agency orders of another market that have been included in the SuperMontage for execution purposes. If, however, Nasdaq as an exclusive processor is publishing depth of book for the SuperMontage, it would need to disseminate similar depth of book that another UTP Plan participant wished to display. The Commission believes that it is sufficient that agency orders of other markets receive parity with quotes/orders of market makers and ECNs. Further, with respect to the commenter's other concern regarding the applicability of the Firm Quote Rule to orders received from UTP Exchanges, the Commission notes that NASD Rule 4710(b) requires market makers to accept and execute non-directed orders against their quotes.

With respect to concerns raised by another commenter regarding revenue appropriation from the sale of quotation and last sale data generated by agency orders from UTP Exchanges and executed within the SuperMontage, the Commission notes that the UTP Plan outlines the responsibilities of UTP Plan participants, but does not provide a comprehensive or exclusive set of terms that govern the interaction of the markets. Because the UTP Plan

only covers distribution and other basic terms, it is not uncommon for the NASD and UTP Plan Participants to negotiate terms for dealing with each other. Therefore, the Commission expects that these issues will be resolved among the participants of the UTP Plan. For instance, the NASD negotiated the terms of SuperMontage participation with the UTP Plan's only active participant, the CHX.[315]

5. Five-Second Interval Delay

As originally proposed, after all interest was exhausted at a price level, the SuperMontage would have imposed a limited 5-second interval delay before moving to the next price level. Two commenters questioned whether the proposed 5-second delay would reduce volatility in the markets as intended.[316] In addition, four commenters believed that the 5-second interval delay either was too long or too short, depending on activity in the stock.[317] Two commenters also opposed the 5-second interval delay as unnecessary and inconsistent with the interest of investors.[318] Specifically, one commenter believed that the delay would permit market makers, ECNs, and UTP Exchanges to decline to fill a non-Liability Order before moving their quotes to an inferior price.[319] This commenter believed that the ability of a market participant to consider whether to decline or accept an execution at a published quote would interfere with the need of investors and traders for certainty and could result in executions at inferior prices.[320]

In response to these comment letters, the NASD revised its process.[321] The SuperMontage, subject to the exception for orders designated as Sweep Orders, will limit the 5-second interval delay to situations where an order is partially filled at the inside price and the remaining shares of the order cannot be filled within the next two trading ticks. In this situation, there will be an interval delay or pause before the order moves to the next price level away from the original price level. If, at any point, the remainder of the order can be filled within the next two trading ticks, the order will be executed immediately. If an order is in interval-delay because it meets the above parameters, orders that are behind the "interval-delay order" will not jump the queue. In addition, a market participant may set a parameter on individual orders so that these orders will trade through all interest (*i.e.*, displayed and reserve interest) at the three price levels being displayed in the NODF at the time of entry, without pausing 5 seconds in between each displayed price (*i.e.*, a Sweep Order).

One commenter supported the limited 5-second interval delay between price levels, and the proposed Sweep Order parameter.[322] However, the commenter was still uncertain if the NASD's modifications to the process went far enough to address concerns about SuperMontage- imposed trading delays.[323]

The Commission finds that the limited 5-second interval delay is consistent with Sections 15A(b)(6) and 11A of the Act[324] in that it is designed to facilitate transactions in securities and maintain a fair and orderly market. The 5-second interval delay is designed to provide Nasdaq Quoting Market Participants and UTP Exchanges with adequate time to update their quotes, without unduly delaying executions. The Commission believes that the 5-second interval delay could assist market makers in fulfilling their obligation to maintain continuous two-sided quotes, and, in turn, could promote quote competition among all market participants. The Commission notes that during the 5-second delay it will be possible for market makers and other market participants, who are not at the inside quote, to change their quotes

to the inside because of market interest. Such competition should, in turn, enhance the quality of the Nasdaq market by improving the price discovery process for Nasdaq securities. The Commission also believes that the delay could help stabilize the market during periods of volatility by allowing Nasdaq Quoting Market Participants and UTP Exchanges the opportunity to monitor and assess their quotes in a reasonable manner in response to changing market conditions.[325]

The Commission believes that the two exceptions to the 5-second interval delay between price levels (for orders that can be filled at the initial price level and within the next two price ticks away and orders designated as Sweep Orders) provide a reasonable compromise between the need for fast executions and the need to provide market participants adequate time to manage their capital risk by monitoring and updating their quotes. Finally, the Commission expects that NASD will monitor market performance in the SuperMontage as it relates to the five-second interval delay, particularly the potential for queuing, and consider modifying that time period, if modification is necessary.

E. Directed Orders

As proposed in the original notice, directed orders would have allowed Nasdaq market participants to deliver a non-Liability Order[326] to a Nasdaq Quoting Market Participant or UTP Exchange only if the order was designated as AON or MAQ for a size that is at least one normal unit of trading (*e.g.*, 100 shares) greater than the displayed amount of the quote/order to which the order is directed.

One commenter believed that directed orders away from the BBO should be treated as Liability Orders.[327] Another commenter expressed concern that if a recipient accepts a directed order for execution, a trade-through could occur if that order is executed at a price outside of the displayed price.[328] This commenter recommended adding a "clean-up" feature for directed orders pursuant to which a directed order could be executed only if the order satisfied the interest displayed on the proposed system at better prices (with no five-second delay if within two price levels from the inside quote if the order goes through several price levels).[329] Two commenters also recommended developing a workable trade-through rule, in conjunction with the Order Execution Algorithm, to provide incentives for the entry and protection of better-priced quotes displayed in the system.[330] Two other commenters argued that the order routing process as proposed would not allow customers to preference them.[331] They stated that the non-directed order process offered no capability for preferencing, and the directed order process offered an ineffective way of preferencing because all directed orders must be designated as non-Liability Orders.[332]

In response to these comments, the NASD revised the proposal to allow Nasdaq Quoting Market Participants and UTP Exchanges to elect to receive Liability Orders through the directed order process.[333] Under the proposed change, a Nasdaq Quoting Market Participant or UTP Exchange can choose to receive a directed order against its quote that is also a Liability Order. A market participant also can choose to accept directed orders against its quotes only as non-Liability Orders.[334] Thus, for example, a market maker can choose to receive both non-directed and directed Liability Orders, or it can choose to receive only non-directed orders on a liability basis. The NASD and Nasdaq have indicated that ECNs that opt to receive directed Liability Orders will avoid dual liability because they will retain the ability to

fill, partially execute, or decline a directed or non-directed Liability Order.[335]

One commenter believed that the NASD's change provided a partial solution, but expressed concern that it will subject market makers to double liability if market makers elect to receive directed Liability Orders.[336] Another commenter believed that allowing directed orders would permit trade-throughs to occurs.[337] One commenter stated that directed orders would limit the ability of institutional traders to effectively participate in the SuperMontage.[338]

The Commission believes that these proposed rules are in accordance with Section 15A(b)(6) of the Act[339] because they are designed to facilitate transactions in securities, remove impediments to and perfect the mechanism of a free and open market and national market system. While the Commission recognizes the concern raised by one commenter regarding the potential double liability of market makers, the Commission also recognizes that market makers are not required to receive directed Liability Orders. If a market maker does not elect to receive directed Liability Orders, the market maker will not be exposed to double liability.[340] Reducing the potential for dual liability may encourage market makers to display larger sized quotations, thereby providing greater liquidity to the market for Nasdaq securities. Further, the "request a cancel" feature limits the exposure of Nasdaq Quoting Market Participants and UTP Exchanges by allowing participants to fill directed non-Liability Orders without being exposed to a dual execution. At the same time, ECNs and others that choose to use the directed order process to take Liability Orders may do so.

The Commission emphasizes, however, that while directed orders are not necessarily inconsistent with the achievement of best execution, a market participant must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most advantageous terms for its customers' orders. Thus, a participant may not simply employ default order routing to a broker-dealer affiliate or particular NASD member without undertaking such an evaluation on an ongoing basis.[341]

F. Locked/Crossed Markets

Generally, under Nasdaq's proposal, if a Nasdaq Quoting Market Participant or UTP Exchange enters an order that will lock or cross the market, the OCF will not display the order as a quote/order, but instead the order will be treated as a marketable limit order and entered into the OCF as a non-directed order for execution. If the market is locked or crossed at the opening, the system will clear the locked or crossed quotes by executing the oldest bid (offer) against the oldest marketable offer (bid) at the price of the oldest quote/order.

One commenter believed that locked or crossed markets at the opening should be resolved in price/time and not time/price priority.[342] Another commenter stated that the potential for locked or crossed markets will continue to exist if ECNs opt to take order delivery for Liability Orders.[343] The commenter believed that the problem would be alleviated if ECNs were required to receive automatic executions.[344] However, as described in greater detail previously, the NASD believes that it is necessary to accommodate the needs of ECNs by providing them with an alternative to automatic execution.

In addition to the issues raised above, one commenter questioned the manner in which the NASD proposed to resolve locks and crosses on the opening of the market.[345] This commenter stated that, as proposed, the system will permit participants to enter non-firm quotes up until the opening and then execute the oldest bids against the oldest offers at the open.[346] This commenter opined that in this system market participants will have no incentive to find the correct price for a stock before the opening.[347]

Another commenter raised the concern that SuperMontage will subject ECNs to an unacceptable risk of automatic execution by converting ECN quotes into orders when they lock or cross the market.[348] This commenter explained that ECNs are not capable of receiving automatic executions because they do not take proprietary positions and therefore, cannot accept the risk of multiple executions against their quotes.[349]

The NASD responded by explaining that when a market participant enters a locking or crossing quote into the system, it will receive a system warning, as it does today.[350] In order to complete the quote entry, the participant is required to override the system warning. After overriding the warning, the quote results in an order being generated that accesses the quote that will be locked or crossed. Therefore, the NASD stated, ECNs can avoid automatic executions for their own quotes by not overriding the system warning.[351]

The NASD added that ECNs are not at risk if another participant enters a quote/order that locks or crosses an existing ECN quote. If that occurs, the system again will issue a warning to the party attempting to lock or cross the market. If that party overrides the system warning, the system will then convert the locking or crossing quote and process it as a non-directed order. It will not deliver an automatic execution to an ECN that chooses to accept only order delivery against its quote. In either case, there is little or no risk to an order delivery participant of an unwanted automatic execution.[352]

The Commission finds that the proposal's provision to address locked and crossed markets is consistent with the Act because it is designed to reduce the frequency of locked and crossed markets, which should help to provide reliable quotation information, facilitate price discovery, and contribute to the maintenance of a fair and orderly market. The proposal also should facilitate more efficient openings. The proposal seeks to eliminate locked and crossed markets by matching marketable orders against one another, after providing notice that an execution will occur. The Commission believes this approach is reasonable. As the Commission has concluded previously, continued locking and crossing of the market can negatively impact market quality.[353] By helping to reduce the frequency of locked and crossed markets, the Commission believes that the proposal should improve market quality and enhance the production of fair and orderly quotations.

While the Commission understands the commenter's concern that the proposal will not completely eliminate crossed and locked markets because ECNs will be given the option of taking order delivery for Liability Orders rather than automatic executions, the ECNs still will be required to execute the locking order immediately, and Nasdaq will decrement the ECNs' quote upon delivery of the order. Thus, the lock or cross should be removed quickly. In addition, as stated previously, the Commission believes the NASD's position that, despite this negative aspect, it is necessary to accommodate the ECNs by providing them with an alternative to automatic execution is consistent with the Act.

G. UTP Exchange Participation as Automatic Execution Participants

One commenter supported UTP Exchange participation in the SuperMontage and stated that the proposal represented a "positive step in integrating the Nasdaq and UTP Exchange markets."[354] This commenter, however, stated that as a purely legal matter, the proposal could not be implemented without an amendment to the UTP Plan because certain features of the proposal change the obligations of Nasdaq under the UTP Plan.[355]

In the original proposal, UTP Exchanges had the option of receiving orders either for delivery or automatic execution, but they were only permitted to send orders to the SuperMontage for order delivery. Some commenters disapproved of this approach. Specifically, they argued that incoming UTP Exchange orders should be subject to automatic execution, so that market makers could avoid having duplicate systems solely to service UTP Exchanges.[356] While one commenter acknowledged the rationale behind the proposal's exclusion of UTP Exchanges from automatic execution, it argued that their inclusion was "in the best interests of all market participants," and that such inclusion would be equitable if UTP Exchanges provided reciprocal automatic execution capability to incoming market maker orders.[357] The Chicago Stock Exchange also objected to the inability of UTP Exchanges to participate in automatic executions and the prioritization of UTP Exchanges in the Order Execution Algorithm.[358]

Another commenter acknowledged that it would be difficult for the NASD to surveil, and if necessary, discipline UTP Exchange members for "backing away" from their quotes, and suggested that potential solutions should be considered.[359] In addition to the duplicate systems issues, the commenter cited a potential loss of liquidity that would result if UTP Exchanges and ECNs did not participate in automatic executions.[360]

In response to concerns about UTP Exchange participation as originally filed, the NASD amended the proposal to give UTP Exchanges the option to receive automatic executions in the SuperMontage, provided that they give Nasdaq reciprocity.[361] In addition, UTP Exchanges will still have the option of accepting order delivery rather than automatic execution.[362]

One commenter objected to what it considered to be the unnecessarily disparate treatment for order-delivery UTP Exchanges and order-delivery ECNs that attempt to access other participants.[363] The commenter noted that order-delivery ECNs will have the ability to automatically execute against other participants, but order-delivery UTP Exchanges will not.[364] The commenter believed that this was done to put order-delivery UTP Exchanges at a competitive disadvantage.[365] Another commenter also disagreed with the NASD's proposal to provide a UTP Exchange automatic executions against Nasdaq's market only if the UTP Exchange is similarly willing to provide automated execution against its quotes.[366] The commenter believed that it was possible to promote inter-exchange competition without requiring UTP Exchanges to become part of Nasdaq's limit order book.

The Commission believes that the NASD's treatment of UTP Exchanges is consistent with the Act. While the Commission believes that it is reasonable for the NASD to attempt to accommodate the various needs of its members, the Commission does not believe that NASD must make the same accommodations for competing markets. The Commission believes that Nasdaq should be able to provide access to a competing exchange that

is equivalent to the access the competing exchange provides for Nasdaq members.[367] In addition, the Commission notes that the SuperMontage is voluntary and that UTP Exchanges may elect to post their quotes/orders in the NASD's display alternative.[368]

H. Odd-Lot Processing

Certain commenters criticized the original proposal for handling limit orders, saying that it would be "cumbersome" and create the opportunity for "gaming the system"[369] by breaking large orders into odd-lots so that those orders would not affect the published quote.[370] Four commenters also expressed concern that dealers without a current interest in a security would be forced into executions under the proposed odd-lot processing method.[371] At least one commenter opined that the proposed odd-lot processing would impose unnecessary administrative and operational burdens on firms,[372] and several commenters raised issues regarding decrementing a market maker's bids and offers.[373]

In response to these comments, the NASD revised its proposed odd-lot execution process.[374] Under the current proposal, the SuperMontage will include a separate mechanism for processing and executing odd-lot orders at the inside price that will provide: (1) an "odd-lot exposure limit" for market makers; (2) a market maker interval delay between odd-lot executions against the same market maker; and (3) an odd-lot order entry parameter of one order per second, per firm. Odd-lot orders will be processed in a round-robin fashion against a market maker with an available exposure limit, even if the market maker is not at the inside.[375] One commenter argued that ECNs should be permitted to interact with odd-lot orders.[376]

The Commission believes that the proposed rule change allows for greater market maker participation in executing odd-lot orders. The Commission also believes that allowing all market makers registered in a security to participate in executing these orders should strengthen the Nasdaq market and benefit market participants by permitting the prompt, efficient execution of odd-lot orders.[377] Market makers may elect to execute odd-lot orders at the inside price even when the market maker is not at the inside bid/offer, thereby adding to the depth and liquidity of the market. The Commission notes that historically only market makers have participated in the odd-lot process because ECNs do not take proprietary positions. If an ECN were to participate in the revised odd-lot process, it would have to take proprietary positions from time to time because it would be required to execute at the inside quote.[378] The Commission believes that the proposed odd-lot system is consistent with the Act based on the current roles of market makers and ECNs, but believes that Nasdaq should explore including ECNs in the odd-lot execution process if ECNs can demonstrate that they can provide equivalent treatment to these orders as market makers.

I. Issues Relating to Competition

1. Centralization

Many commenters believed that the proposal will improve the Nasdaq market by providing more information to investors, promoting greater efficiency in executions, or increasing overall market transparency.[379] One commenter believed that the SuperMontage is greatly needed and "that it

will eventually make the market more efficient and competitive, all to the benefit of the investor."[380] Another commenter stated that the SuperMontage will improve the Nasdaq market and integrate "market makers, ECNs and UTP Exchanges in a more unified, competitive manner."[381] One commenter also believed that the SuperMontage will "continue a natural competition between securities markets."[382] Another commenter stated that the SuperMontage was "an inclusive model built with the connectivity to link all market participants, including electronic communications networks into the market center. However, it in no way imposes new obligations or burdens, or diminishes the opportunity for market participants to interact with one another through other means."[383] In addition, one commenter, after Amendment No. 8, stated that the "SuperMontage has been transformed from a revolution in fundamental market structure to an incremental evolution in market technology characterized by a marketplace that preserves investor choice and competition."[384]

Fourteen commenters, however, were concerned that the proposal will have a negative impact on competition.[385] Most of these commenters argued that the proposal was anti-competitive because, in their view, it will implement a monopolistic, centralized execution system that will compel participation by NASD regulated broker-dealers, and in turn stifle ECN innovation and diminish market competition. Several commenters also expressed concern that the automatic execution feature of the SuperMontage will have a negative impact on competition by forcing order flow into the SuperMontage.[386] Specifically, Instinet stated that, because of the NASD's status as a regulator, the NODF will effectively become a mandatory display facility for investors' orders to the exclusion of more efficient, better-priced pools of liquidity.[387] Instinet believed that Nasdaq's affiliation with NASD Regulation will create the perception among Nasdaq Quoting Market Participants that customer orders routed to the SuperMontage will be insulated from best execution challenges.[388] Instinet thus asserted that liquidity provided by other facilities could evaporate, and that investor order display and execution options will diminish.[389] Instinet also argued that Nasdaq will have a regulatory advantage over ECNs because of its ability to subsidize market operations from the revenues that Nasdaq earns from the sale of market data.[390]

Phlx believed that the SuperMontage will result in an "unacceptable concentration of market power in the NASD at the expense of the regional exchanges . . . . Under the SuperMontage proposal, Nasdaq will function as its own ITS. . . . [without providing] for any representation."[391]

In response, the NASD stated that, while the proposal creates a central means for accessing liquidity in Nasdaq and other market centers, it in no way establishes the SuperMontage as the sole means for providing or accessing liquidity. NASD members, individual investors, and members of other exchanges will be free to route their orders to any market center they choose. Moreover, ECN subscribers will be free to use the execution services offered by the ECNs to access liquidity within the ECNs. The NASD emphasized that nothing in the proposal prohibits ECNs and other market participants from establishing links or order-routing arrangements.[392] The NASD maintained that providing a means for accessing liquidity and trading interest is an essential and core function of a market. The NASD pointed out that it already provides both quotation and execution services. Nasdaq has operated SOES since 1984, and SelectNet since 1988, both of which are integrated with Nasdaq's quotation system. The NASD believes that eliminating this capability would be a step backward for the market and

investors, and would be contrary to Sections 11A and 15A of the Exchange Act as it will foster inefficiencies in the execution of securities, minimize opportunities to obtain best execution, limit market linkages, result in disorderly markets, and ultimately harm investors.[393]

The Commission believes that the SuperMontage does not impose any burden on competition that is not necessary or appropriate in furtherance of the Act. The Commission has long held the view that competition and innovation are essential to the health of the securities markets. Indeed, competition is one of the hallmarks of the national market system. The SuperMontage is a reasonable effort by the NASD to enhance the quality of the Nasdaq market by providing more information to investors, promoting greater efficiency in executions, and increasing overall market transparency. Although the SuperMontage may provide a new means for accessing liquidity in Nasdaq stocks, the SuperMontage will not be the sole means for providing or accessing liquidity. Under the proposal, broker-dealers may continue to seek alternative order routing and execution services that provide value to their customers through price, speed, and technology. Broker-dealers wishing to interact with institutional orders below the top of the book, for example, may continue to use ECNs.[394] Those that wish to continue to maintain anonymity through clearance and settlement may continue to use ECNs. In addition, market participants wishing to execute orders without the participation of a dealer may continue to do so under the proposal. NQDS Prime will provide all individual attributable quote/order information at the three best price levels displayed in the SuperMontage. With this information, market participants will have the choice of using Nasdaq's facility to access liquidity or private linkages outside of the SuperMontage to access liquidity. Moreover, participation in the SuperMontage is voluntary. A market participant, such as an ECN, may elect not to display, or provide access to, its quotes/orders through Nasdaq and instead display and provide access to its quotes/orders on other markets, such as the Chicago Stock Exchange, the Cincinnati Stock Exchange, and possibly in the future, the Pacific Exchange ("PCX"). In addition, the NASD has agreed to create an alternative quote reporting mechanism that will allow an ECN, ATS, or market maker to maintain its quotes in an NASD facility without being a participant in Nasdaq, and therefore the SuperMontage.[395]

At the heart of the commenters' competition arguments is the view that automatic execution against market makers gives the SuperMontage an unfair advantage in drawing order flow and makes it difficult for others to build competing links to market makers. The Commission finds that the automatic execution feature offered by the SuperMontage is a reasonable way for Nasdaq to improve market efficiency. Since at least 1988, automatic execution has been a vital element of Nasdaq's dealer market. The NASD's automatic execution system, SOES, was initially developed in 1984 to provide an efficient facility for order entry firms to execute retail customer orders of limited size in Nasdaq securities.[396] SOES offered an alternative for those firms to the traditional telephone contact and negotiation with market makers by providing automatic execution of customer orders against Nasdaq market makers at the best available market price.

Initially, participation in SOES was voluntary. During the October 1987 market break, however, the Nasdaq market experienced significant operational problems.[397] Sharp downward volatility and record volume resulted in delayed transaction reports and a large number of locked and crossed markets. The unusual market conditions created a situation in

which it was impossible for market makers to ensure that their quotes, against which trades were continuing to be executed in SOES, accurately reflected the rapidly changing market. Because participation in SOES at that time was voluntary, a majority of market makers responded by withdrawing from SOES.[398] Trades that normally would have been handled through SOES then had to be executed by contacting market makers by telephone. This necessarily increased the already extraordinary workload of market makers and contributed to a large number of unfilled orders, as well as complaints that market makers were not accessible.

In response to those problems, the NASD adopted a number of rules to facilitate the execution of retail customer orders in SOES and to ensure market maker participation in the system ("1988 SOES modifications"), including making SOES participation mandatory for all market makers in Nasdaq securities.[399] These changes were intended, among other things, to ensure that order entry firms could obtain automatic executions for their customers in volatile markets. Upon approval, the Commission stated its belief that the 1988 SOES modifications would enhance market liquidity, improve the accuracy of Nasdaq's pricing systems, promote the timeliness of trade reporting, and help alleviate locked and crossed markets.[400]

In 1999, the NASD recognized that, while SOES and SelectNet provided valuable services to market participants, the operation of two separate and independent execution systems resulted in frequent dual liability for market makers. In response to this problem, the NASD proposed to integrate SOES and SelectNet, and re-establish SelectNet as a non-Liability Order delivery and execution system for Nasdaq National Market System securities and recast SOES as the NNMS. The Commission approved the integration on January 25, 2000.[401] Pursuant to the NNMS Order, the maximum order size now eligible for automatic execution in Nasdaq National Market System securities is 9,900 shares. Further, the NNMS Order permitted market makers to enter both proprietary and agency orders into NNMS, and receive executions.

The Commission continues to believe that automatic execution provides many benefits to a marketplace, particularly speed and certainty of executions. As the NASD pointed out, certainty of execution is important to all investors, particularly in fast moving markets. The automatic execution feature of the SuperMontage should promote investor confidence by increasing the likelihood that orders of moderate size from large and small investors alike will be filled almost instantaneously. The SuperMontage's automatic execution feature also should improve the accuracy of Nasdaq's pricing systems, promote the timeliness of trade reporting, and help alleviate locked and crossed markets. Further, the Commission notes that the SuperMontage does not dramatically modify the automatic execution feature in NNMS, which was approved by the Commission after being published for comment.

In a comment letter prior to Amendment No. 8, Bloomberg suggested an alternative, hybrid approach to automatic execution, in which Nasdaq could send order messages that converted into executions within a fraction of a second if market makers failed to respond.[402] Bloomberg stated that such a hybrid approach, which is both technologically feasible and affordable, would promote the use of automatic execution facilities among market professionals and enhance market efficiency.[403]

In response, the NASD stated that Bloomberg's approach could harm investors, particularly small investors, because there no longer would be a

method of providing automatic execution to small orders. Further, the NASD stated that if all market participants receive only orders (as opposed to executions), which they may reject in full or fill partially, investors' orders would be "bounced" from one market participant to another. Thus, this approach could result in orders that are entered later in time being filled before orders that are entered earlier in time, depending on how and when the market participant receiving the order responds to the order.[404]

The NASD also noted that, under Bloomberg's alternative, instances of backing away could increase, particularly because it could exacerbate the dual liability problem that many market makers face today. Automatic execution, in comparison, reduces the potential that a market participant may back away from its quote.

Finally, the NASD argued that automatic execution significantly reduces the potential for locked and crossed markets. The NASD stated that its proposal will reduce instances of locked/crossed markets because a substantial number of market participant quotes will be subject to automatic execution. The NASD questioned whether Bloomberg's proposal would be equally effective in addressing locked/crossed markets, especially because the system presumably would not move stale quotes out of the way to resolve a locked/crossed market. Rather, under Bloomberg's proposal, the system would continue to deliver orders and default to executions against a stale quote. The quote would have to be manually removed before the lock/cross could be resolved.[405]

The Commission does not believe that Bloomberg's suggested hybrid approach would necessarily be as effective as the approach proposed by Nasdaq. A hybrid order delivery system would require the NASD to constantly monitor dealer executions to prevent instances of backing away outside of the system. It also would be less effective in addressing locked and crossed markets. In addition, the Commission notes that the NASD has represented that order delivery messages use significantly more message capacity than order execution messages. Thus, an increased reliance on automatic executions could reduce network traffic and increase speed and reliability of the entire Nasdaq market.[406] As discussed further below, the NASD has represented that a system based on an automatic execution platform can be expanded rapidly to handle any increased volume of message traffic.[407]

Finally, Instinet and Bloomberg argued that the order display and order routing facilities of the SuperMontage should not be linked to the order matching facility of the SuperMontage. Instead, Instinet and Bloomberg believed that Nasdaq's order display and routing facilities, which the NASD proposes to continue operating under the SuperMontage, should be separate from its proposed order matching facility.[408]

In the Commission's view, however, the SuperMontage not only builds on the order execution foundation laid by SOES and NNMS, but represents another step in the ongoing technological evolution of the U.S and global securities markets. This past year, for example, the Commission approved the first completely electronic options exchange, the International Stock Exchange.[409] The Commission also just approved a proposed rule change by the New York Stock Exchange to implement NYSe Direct+, which would provide automatic executions for certain limit orders of a specified size.[410] PCX also recently proposed to incorporate automatic execution into its trading platforms and create an electronic book for its equities business by operating the Archipelago Exchange as a facility of the PCX.[411]

These market developments are consistent with -- and indeed, were foreshadowed by Congress in -- Section 11A of the Exchange Act. In Section 11A, Congress recognized that technology would drive competition among the securities markets, stating that "[n]ew data processing and communications techniques create the opportunity for more efficient and effective market operations."[412] The Commission believes that SuperMontage proposal is consistent with Section 11A in that it incorporates new technological features to provide investors with the opportunity to receive economically efficient execution of their securities transactions and to promote fair and orderly markets.[413] It is not only essential that investors have the ability to see the depth of the supply and demand in a security, but also that they have the ability to access the depth of the supply. The SuperMontage will provide a new means of accessing that liquidity.

2. Other Issues Relating to Competition

Several commenters expressed concerns about the NASD's dual role as an operator of a market (*i.e.*, Nasdaq) and as a self-regulator.[414] Specifically, one commenter believed that the NASD will use its regulatory powers to "nourish the private ECN" and thereby restrain competition,[415] while another commenter believed that Nasdaq's regulatory privileges will inhibit competition and force market participants to accept what Nasdaq offers.[416] Other commenters viewed the proposal as an inappropriate attempt by the NASD to compete with its own members' trading systems, particularly ECNs, using the revenues generated by those participants to finance the SuperMontage.[417] Two commenters believed that the SuperMontage would receive financial subsidies from Nasdaq's market information revenues.[418] Three commenters believed that the NASD has an inherent conflict of interest with respect to the competing interests of market makers and order entry firms.[419] Another commenter believed that Nasdaq's interests will diverge from its market participants as it begins to compete with market makers and ECNs for executions.[420] One commenter urged the Commission to supervise the NASD's "competitive stance" so that "no unfair advantage over market participants is created or even perceived."[421] Another commenter recommended that the NASD "divest itself of its residual interest in Nasdaq" to reduce anti-competitive conflicts.[422] Finally, several commenters opined that the NASD's conflicts of interest might become more pronounced with Nasdaq's announced intention to demutualize.[423]

Another commenter questioned whether Nasdaq will use market data compiled by the NASD Automated Confirmation of Transactions ("ACT") facility and OATS.[424] This commenter argued that because ECN competitors of the SuperMontage will not have access to this data, Nasdaq should not have access to the data and should be required to compete on equal ground with other trading systems.[425] To permit Nasdaq to use this information, the commenter argued, would allow Nasdaq to use its affiliation with NASD to unfairly compete for customer orders.[426]

Three commenters also expressed concern about the potential fees the NASD might charge for access to the SuperMontage.[427] One commenter stated that the NASD would have no incentive to control costs associated with the SuperMontage because it would be a monopoly.[428] This commenter noted that currently it costs twice as much to execute a trade through SelectNet as it does on the Island ECN.[429] The commenter attributed the difference in cost to the fact that Island has competitors

while SelectNet has a unique relationship with the NASD.[430] The commenter opined that the fees associated with the SuperMontage will exceed those for SelectNet as a result of the monopoly created.[431]

The Commission recognizes the concerns of the commenters, but notes that many of these conflicts are inherent in the self-regulatory model. Indeed, the Act specifically contemplates that SROs not only will act as regulators, but also will operate markets.[432] For instance, the Act authorizes the Commission to oversee SRO functions to address the inherent conflicts of the self-regulatory model, and to attempt to ensure that an SRO does not secure advantages as a commercial entity by virtue of its regulatory authority. Among other things, the Commission must find that the rules of the NASD provide for fair representation of its members, appropriate discipline for violations of the Act, and a fair procedure for disciplining members.[433] The NASD is required to file proposed rule changes with the Commission when it establishes fees, and these fees must be reasonable and equitably allocated among members, issuers, and other persons using any facility or system of the SRO in accordance with Section 15A(a)(5) of the Act.[434] Further, NASD trading rules, such as the SuperMontage proposal, are subject to the Commission's rule review process. This process provides the opportunity for interested parties and the public to voice their comments and concerns about proposed rules to the Commission. Moreover, the Commission, through inspections, vigilantly monitors all SROs, including the NASD, for objective compliance and enforcement of their rules. Thus, through oversight, inspection, and provisions designed to ensure due process, the Act has provided, and the Commission implements, significant safeguards that serve to address the conflicts inherent in the self-regulatory model and that protect the legitimate interests of SRO members.

It would be inconsistent with the NASD's self-regulatory responsibility for the NASD to use its regulatory power to advance Nasdaq's market interests to the detriment of its members, and the Commission intends to be vigilant to prevent this. As a result, the NASD will not be able to use its regulatory authority to act in any manner in preference to, or prejudice of, Nasdaq or any other stock market, marketplace, or market participant[435] generally or specifically because of that entity's relationship to the SuperMontage or Nasdaq.[436] For example, the NASD has no rule that would require the use of the SuperMontage for execution of orders; and such rules or interpretive positions clearly would be inappropriate.[437] Further, the operation of the SuperMontage by an affiliate of the NASD does not validate its use to satisfy best execution obligations, or replace the required regular and rigorous review by broker-dealers of execution quality available from different markets. Broker-dealers will continue to have the responsibility to make an independent determination of how to obtain best execution of their customers' orders.

In addition, the Commission believes that NQDS Prime should help eliminate any informational advantage accruing to the SuperMontage. Further, Nasdaq has asserted that it will not use information about the source and scope of a reserve size quote to influence reserve size execution priority within SuperMontage, or provide optimized reserve size executions based on information residing solely in the SuperMontage.[438]

Finally, the Commission notes that, under Regulation ATS, ECNs may choose whether to register as national securities exchanges and become their own SRO, or to register as broker-dealers and comply with the requirements of another SRO.[439] Today's regulatory structure is designed

to provide all market centers with structural flexibility in order to enhance competition between market centers, while promoting market fairness, efficiency, and transparency.

3. Nasdaq as an Exclusive Securities Information Processor

Prior to Amendment No. 8, several commenters asserted that the Nasdaq as an exclusive securities information processor ("SIP") can compel the submission of quotations to Nasdaq.[440] As such, commenters believed that the NASD could compel the submission of orders through the SuperMontage.[441] Also, two commenters stated that Nasdaq's proposed treatment of UTP Exchanges' principal interest is inconsistent with its role as the exclusive SIP, and will discourage competition with competing exchanges.[442]

Several commenters questioned whether the SuperMontage would impact Nasdaq in its capacity as an exclusive SIP.[443] Archipelago stated that Nasdaq could use its status as an exclusive SIP to gain competitive advantages not available to ECNs. Specifically, Archipelago maintained that Nasdaq, as an exclusive SIP and the operator of the SuperMontage, could access the ACT and OATS systems to analyze the trading activity of competitive systems and the order routing practices of all market participants to garner competitive advantages. Archipelago stressed that Nasdaq, as a market operator, should not be allowed to compete unfairly for order flow through its role as an exclusive SIP. Both Archipelago and Instinet suggested that the SuperMontage would contravene the congressional intent that Nasdaq, as an exclusive information processor, act in a "manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms."[444] Instinet suggested that the proposal, as amended, would allow Nasdaq to use its regulatory advantages and status as an exclusive SIP to lock in its competitive position in the marketplace. Archipelago suggested that Nasdaq would not operate in a manner that is absolutely neutral with respect to market centers because ECNs and UTP Exchanges would be disadvantaged by the SuperMontage's Order Execution Algorithm.

To address concerns about mandatory participation in Nasdaq, in publishing Amendment No. 8 for comment, the Commission noted that the NASD agreed to provide an alternative quotation and transaction reporting facility for NASD members.[445] In response to Amendment No. 8, several commenters expressed concern that Nasdaq's regulatory and competitive advantages were not adequately addressed.[446] In particular, commenters indicated that Nasdaq's operation of the SuperMontage and status as an exclusive SIP presented a conflict of interest.[447] Commenters questioned whether Nasdaq could be a truly voluntary facility as long as it retained its status as an exclusive SIP.[448] Commenters suggested that a meaningful display alternative to Nasdaq for OTC securities would have to exist prior to the SuperMontage's implementation in order to truly make the SuperMontage voluntary.[449] Commenters also asserted that the Nasdaq, as an exclusive SIP, is mandated by Congress to operate in a manner that is "absolutely neutral with respect to all market centers."[450]

One commenter questioned whether SIP neutrality was possible since "[o] nce Nasdaq enters the execution business, it itself becomes a market center. . . ."[451] One commenter stated that the only way Nasdaq could fulfill the dual roles of a securities market and exclusive SIP would be to treat NASD members and UTP Exchanges equally.[452] Another commenter

stated that the SuperMontage should be approved only within the context of a broader program of reform of Nasdaq's role in OTC market structure that leaves Nasdaq to compete on the merits of its technology and vision with no regulatory advantages.[453] Some commenters suggested that if Nasdaq was not required to divest itself of its SIP status, irreparable harm could be done to the competitive landscape for Nasdaq traded securities.[454]

One commenter expressed concern that if Nasdaq becomes a registered exchange, stocks traded on Nasdaq would be excluded from the NASD display alternative.[455] Instinet stated that a neutral and viable alternative facility for all Nasdaq stocks with sufficient technological resources should be available prior to approval of the SuperMontage. Instinet also believed that Nasdaq's role as SIP for Nasdaq-listed securities should be discontinued[456] and the SIP for Nasdaq securities should not be affiliated with any market center. Instinet said that ownership, governance, and market data revenue of such a SIP should be broadly shared among market centers or vested through a competitive bidding process. Instinet also stated that all market centers should have direct access to the SIP's facilities and that its order routing and execution functions should not privilege any market center's individual liquidity pool over another's.

In the early 1970's, the Commission took the initial steps toward creating a central market system in which investors would have access to information from all markets. Congress adopted this fundamental policy determination when it enacted the Securities Acts Amendments of 1975 ("1975 Amendments").[457] To implement the national market system, the Commission has required the SROs to act jointly pursuant to various national market system plans in disseminating consolidated market information. These plans govern all aspects of the arrangements for disseminating market information. Among other things, they require the individual SROs to funnel market information to a central processor, which then consolidates the information into a single stream for dissemination to the public. In this way, the public is assured of access to a highly reliable source of information that is fully consolidated from all the various market centers that trade a particular security.

Currently, Nasdaq is registered with the Commission as an exclusive SIP under Section 11A(b) of the Act.[458] Nasdaq functions as an exclusive processor in two separate but closely related activities. First, it is responsible for the collection of quotation and transaction information for the OTC market in Nasdaq-listed securities pursuant to NASD rules. And, second, it is the processor for the UTP Plan.

The UTP Plan was jointly developed and negotiated by its participants, the American Stock Exchange ("AMEX"), CHX, NASD, PCX, and the Phlx.[459] The UTP Plan provides for an Operating Committee composed of one representative for each participant. The responsibilities of the Operating Committee include oversight of the consolidation and dissemination of quotation information and transaction reports, evaluating the processor, and determining cost allocation and revenue sharing. The Operating Committee, by majority vote of the full participants, also may terminate the processor, for cause, if it determines that the processor has failed to perform its functions in a reasonably acceptable manner, or that its reimbursable expenses have become excessive and are not justified on a cost basis.[460]

Under NASD Rules, Nasdaq, acting on behalf of the NASD, collects and prepares for distribution information concerning quotations and transactions

in the OTC market for Nasdaq-listed securities, including Nasdaq National Market System Securities and Nasdaq Small Cap securities. Under the UTP Plan, information concerning quotations and transactions in participant exchange markets for Nasdaq National Market System securities, but not for Nasdaq Small Cap securities, is collected and consolidated by Nasdaq with the information collected by Nasdaq on behalf of NASD. Amendments to the NASD's rules (including changes in market information fees relating to all Nasdaq System securities) are subject to Commission review under Section 19(b) of the Exchange Act.[461] Amendments to the Nasdaq/UTP Plan are subject to Commission review under Rule 11Aa3-2.[462] Participants may withdraw from the UTP Plan with thirty days' prior written notice.

The Commission appreciates concerns about Nasdaq's status as an exclusive SIP, because at the heart of the commenters' exclusive SIP argument is the concern that Nasdaq's role as an exclusive SIP compels SuperMontage participation. To address concerns that Nasdaq has an advantage as the mandatory collector of quotes and trade data for over-the-counter market participants, and thus, that the SuperMontage would be involuntary, the NASD has committed to provide NASD members with the ability to opt-out of the SuperMontage by providing an alternative quotation and transaction reporting facility for NASD members. This would allow NASD members to publish quotes and effect transactions in the over-the-counter market, but not to participate in the OCF function of the SuperMontage.[463] The facility would be designed to allow NASD members to meet their obligations under the SEC's Order Handling Rules and Regulation ATS, as well as any transaction reporting obligations imposed by NASD rules. The NASD intends its display alternative, which would be operational contemporaneously with the SuperMontage, to provide a market-neutral electronic linkage to the Nasdaq, as well as other marketplaces. Thus, Nasdaq's functions as the mandatory over-the-counter data collector will be disentangled from its roles as a self-regulator and market operator.

The Commission believes that the NASD display alternative should help assuage concerns about Nasdaq's competitive advantages, and further distinguish its status as a trading market and the collector of over-the-counter quotes and trades. The Commission, therefore, is conditioning its approval of the SuperMontage on the following, which must be implemented prior to or at the same time as the SuperMontage: (1) that the NASD will offer a quote and trade reporting alternative that satisfies the Order Handling Rules, Regulation ATS, and other regulatory requirements for ATSs, ECNs, and market makers; (2) that NASD quotes disseminated through the exclusive SIP will identify the ATS, ECN, or market maker source of the quote; and (3) that participation in SuperMontage will be entirely voluntary, because NASD quotes will be included in the Nasdaq quotation management system while Nasdaq is the exclusive SIP, but only for display purposes, and the NASD will provide access to its quotes on a market-neutral basis.

The commenters' other concerns about Nasdaq's role as central processor are, in fact, criticisms generally of the current structure for providing consolidated data. They also blur the distinction between the roles of Nasdaq as SIP for Nasdaq's own market, and Nasdaq's role as exclusive processor for all markets trading Nasdaq-listed securities. The operation of SuperMontage's trading system does not depend on Nasdaq's exclusive processor function; rather, UTP Exchanges need not participate in any aspect of Nasdaq other than its consolidation of quotes and trade information. As noted previously, this consolidation function grew out of Nasdaq's origination of this market. It is subject to renegotiation of the

markets trading Nasdaq securities, and as mentioned previously, Nasdaq has indicated that it is willing to confer with all relevant parties about establishing an independent exclusive SIP that is jointly owned by the exchanges that trade Nasdaq securities.[464]

As a separate policy matter, and in light of commenters' concerns, the Commission believes that it is now appropriate for the NASD and the UTP Exchanges to re-evaluate the UTP Plan.[465] The Commission notes that the SuperMontage is being implemented in conjunction with several other market initiatives, such as Nasdaq becoming an exchange,[466] and further, that more exchanges may begin trading Nasdaq securities in the near future. In light of the foregoing and the fact that the UTP Plan will be coming up for renewal and consideration by the Commission within the next few months, the Commission believes that it is appropriate to discuss its concerns regarding the UTP Plan in the context of this Order to initiate a dialog among the UTP Plan participants.

Accordingly, the Commission intends to require as a condition for extending the existing plan beyond the March, 2001 termination date, that there be good faith negotiations among the plan participants on a revised plan for Nasdaq securities that provides for either i) a fully viable alternative exclusive SIP for all Nasdaq securities, or ii) a fully viable alternative non-exclusive SIP in the event that the plan does not provide for an exclusive SIP. If the revised plan provides for an exclusive consolidating SIP, a function currently performed by Nasdaq, the Commission believes that, in order to avoid conflicts of interest, there should be a presumption that a plan participant, and in particular Nasdaq, should not operate such exclusive consolidating SIP. The presumption may be overcome if: i) the plan processor is chosen on the basis of bona fide competitive bidding and the participant submits the successful bid; and ii) any decision to award a contract to a plan participant, and any ensuing review or renewal of such contract, is made without that plan participant's direct or indirect voting participation. If a plan participant is chosen to operate such exclusive SIP, the Commission believes there should be a further presumption that the participant-operated exclusive SIP shall operate completely separate from any order matching facility operated by that participant and that any order matching facility operated by that participant must interact with the plan-operated exclusive SIP on the same terms and conditions as any other market center trading Nasdaq listed securities. Further, the Commission will expect the NASD to provide direct or indirect access to the alternative SIP, whether exclusive or non-exclusive, by any of its members that qualifies, and to disseminate transaction information and individually identified quotation information for these members through the SIP.

The Commission believes that the revised plan should be open to all SROs and that the plan should share governance of all matters subject to the plan equitably among the SRO participants. The plan should provide for sharing of market data revenues among SRO participants. The Commission also believes the Plan should provide a role for participation in decision making to non-SROs that have direct or indirect access to the alternative SIP provided by NASD.

If negotiations among plan participants do not produce a revised plan within six months from the date of this order[467] , the Commission intends promptly to amend the plan directly in a manner consistent with the foregoing.

The Commission also recognizes that the NASD, in its regulatory capacity,

can obtain sensitive market data that could benefit Nasdaq's market operation if used for competitive purposes. Thus, the Commission has received assurances from Nasdaq that it will not use OATS data to gain an unfair competitive advantage over other market participants.[468] The Commission will maintain vigilant oversight of this matter. In addition, in response to the concern that Nasdaq could accrue an unfair informational advantage through the SuperMontage, the filing was amended to provide, on a real-time basis, all individual attributable quote and order information at the three best price levels displayed in the NODF through NQDS Prime, and to identify the sender of all directed orders, delivered non-directed orders, and delivered preferenced orders.[469] The Commission believes that these provisions help to address commenter concerns, and demonstrate the NASD's intent not to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.[470]

Notwithstanding the above, the Commission recognizes that the ongoing evolution of the securities industry requires that traditional interaction of market participants be reevaluated, and may necessitate fundamental structural change. In that regard, the Commission is reviewing SIP and market information arrangement issues in a context separate from the SuperMontage, and has initiated a Market Data Advisory Committee under the Federal Advisory Committee Act. The Commission will continue to consider market data issues, including through its Advisory Committee on Market Data. The Commission may adopt alternative market data approaches that supersede the need for the UTP Plan discussed previously.

4. Commission's Conclusion on Competition Issues

The Commission believes that Nasdaq and traditional exchanges must have the flexibility to rethink their structures to permit appropriate responses to the rapidly changing marketplace. Congress instructed the Commission to seek to "enhance competition and to allow economic forces, interacting with a fair regulatory field, to arrive at appropriate variation in practices and services."[471] The Commission finds that the SuperMontage is consistent with these goals in that it is reasonably designed to promote price discovery, best execution, liquidity, and market innovation, while continuing to preserve competition among market centers.

In addition, the Commission finds that the SuperMontage does not unfairly discriminate among brokers and dealers. First, the Commission notes that the proposal was amended to eliminate distinctions between automatic execution participants and order delivery participants with regard to order execution priority. Second, the proposal always has provided ECNs with the opportunity to participate either as automatic execution ECNs or order delivery ECNs.[472] Third, the NASD amended the proposal to allow ECNs, market makers, and UTP Exchanges to accept Liability Orders through the directed order process. Further, the NASD amended the proposal to have the execution algorithm default to a price/time priority algorithm and allow executions based on priorities other than access fees. By providing ECNs with the option of automatic execution or order delivery, by amending the directed order process, by revising the Order Execution Algorithms, and by giving ECNs that accept automatic executions the ability to request a cancellation in order to avoid dual liability, the Commission believes that the NASD has made reasonable efforts to ensure that ECNs will have the ability to participate fairly in the SuperMontage.[473]

The Commission again notes that mandatory market maker participation in automatic execution is not new. Mandatory market maker participation in

automatic executions has been a characteristic of the Nasdaq market since the 1988 SOES modifications. The Commission believes that many of the same principles that served as a catalyst for the 1988 SOES modifications currently exist, including speed and certainty of executions at the best displayed price, market liquidity and depth, investor protection in fast moving or volatile markets, and the maintenance of investor confidence. These continue to be reasons for automatic executions in the Nasdaq market today.

In the Commission's view, Nasdaq has the right to seek a more efficient model of doing business. Nasdaq, like other markets and market participants, must be permitted to innovate and adjust to the dynamic nature of today's securities industry. The Commission believes that the NASD has developed a reasonable system architecture for the SuperMontage that attempts to strengthen its market while accommodating the business operations and interests of all Nasdaq Quoting Market Participants, and without unfairly discriminating against UTP exchanges. The Commission finds that the proposal is consistent with Section 15A(b)(9) of the Act in that it does not impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.[474] In short, the Commission concludes that the SuperMontage represents a market innovation that is likely to strengthen the Nasdaq market while leaving room for further market initiatives by competing markets and Nasdaq market participants.

J. Technology Issues

Many aspects of the proposal will require significant technological changes to the present system architecture, particularly the NODF and the OCF. Several commenters expressed concern about the NASD's technological capability to implement the proposal, particularly in light of Nasdaq's past system delays and outages, the increased message traffic that could be created by the proposal, and other changes, such as decimalization.[475] Commenters called for Nasdaq to improve its technology and capacity prior to implementing the present changes; to provide assurances that the systems can accommodate any foreseeable market conditions; and to correct any present deficiencies before embarking on the implementation of the SuperMontage.[476] In addition, one commenter believed that all systems specifications should be made available for public inspection and comment.[477] Finally, one commenter expressed the concern that because proposed NASD Rule 4705(g) relieves Nasdaq of all liability for losses stemming from use of the SuperMontage, Nasdaq has no incentive to prevent outages.[478] Given this, the commenter recommended that there be rigid oversight over Nasdaq's system performance.[479]

In response, the NASD stated that, like the commenters, it seriously considered the impact of the increase in trading volume from the new system, and the corresponding stress that such an increase could place on Nasdaq's computer systems.[480] The NASD explained that the NODF has been designed, and will be constructed, around a state-of-the-art "scaleable" architecture that Nasdaq can easily expand to meet future demands on the system. Specifically, the NASD represented that the new architecture for the NODF does not have the limitations associated with the underlying systems for SOES and SelectNet. The NODF architecture has been developed to provide for full horizontal scalability. This means that Nasdaq will be able to run multiple replications of the NODF/NNMS system, called "Security Processors." Each Security Processor will contain the entire NODF/NNMS functionality to support the quotes, executions, and orders for

a given subset of Nasdaq securities. The Security Processors will not communicate with one another in the processing of quotes, executions, or orders. In addition, the NASD noted that Security Processors could be added, as necessary, to allow the system to expand and increase in capacity as volume grows. The NASD stated that the scaleable Security Processor approach should eliminate several different problems that market participants currently encounter, including (1) delays for current users; (2) delays in updating quotes to reflect an execution; and (3) performance problems associated with SelectNet. For the same reasons, the NASD is confident that the NODF will be able to meet all capacity requirements for decimal pricing in the U.S. securities markets.[481]

Further, according to the NASD, the proposed system will not be affected by any announced capacity constraints on Nasdaq's systems because the NODF is based on a different architecture, as described above. Therefore, the capacity constraints Nasdaq experiences with its current architecture will not affect the development or operation of the NODF architecture.

In Amendment No. 5, the NASD further stated that construction of the proposed system has not diverted resources from its continuing decimalization efforts. The NASD emphasized that it has not and will not, in any way, divert technology resources from its decimalization efforts. The NASD represented that the system development team consists of personnel that are exclusively dedicated to the proposed system and are completely separate from other Nasdaq software teams. In addition, the NASD stated that it uses outside consultants to augment internal staff where needed.

Specifically, according to the NASD, the SuperMontage is being built using the Tandem System. On the other hand, Nasdaq is modifying its existing Unisys-based quotation platform to accommodate decimal pricing, and that project is staffed with a dedicated Unisys-based development team.[482] The NASD asserted that personnel resources for decimals will take complete priority over other Nasdaq projects, including the SuperMontage.[483]

Further, the NASD's international development efforts have been out-sourced to separate and distinct teams, with only two individuals coming from existing NASD staff - neither of whom were involved in any related Nasdaq market systems. All systems development for the international markets is being performed by a joint venture company and has no impact on domestic Nasdaq development or resources.[484] Finally, in response to the concerns of some commenters, Nasdaq will attempt to roll out the system on a measured basis.[485]

After considering the above representations, the Commission believes that the NASD has provided the appropriate assurance that Nasdaq has a plan to address the technological concerns and objections raised about the SuperMontage. The Commission notes the importance of the reliability of systems capability and capacity to investors, market intermediaries, and the markets as a whole. The Commission expects the NASD and Nasdaq to continually evaluate and monitor the development of the SuperMontage and to implement any additional technological changes as necessary before fully implementing the system. The Commission also expects the NASD to demonstrate that the development and capabilities of the system satisfy the Commission's Automation Review Policy[486] before implementing the proposed system. In particular, the Commission expects the NASD to provide to the Commission staff documentation called for in ARP II relating to systems change notifications, including, but not limited to: (1) capacity estimates; (2) test plans and schedules; (3) contingency protocols; (4)

vulnerability assessments; and (5) production schedules (*e.g.*, project management and task schedules). The Commission expects the NASD to provide this information as it is developed and prior to testing, as appropriate, and to update periodically this information, including a description of all test results.

Finally, the Commission notes that the NASD has provided assurance that technological resources will not be diverted from Nasdaq's decimalization efforts to any other Nasdaq initiative, including the current proposal. In any case, the Commission notes that the NASD has committed to delaying implementation of the proposed system until *after* the full implementation of decimal pricing.[487]

K. Impact on Competition, Efficiency and Capital Formation

Section 3(f) of the Act requires that the Commission consider whether the NASD's proposal will promote efficiency, competition, and capital formation.[488] As discussed above, the Commission has carefully considered the merits of the issues raised by each of the commenters, and has concluded that the design of SuperMontage, in conjunction with the conditions imposed by the Commission, attempts to accommodate all Nasdaq market participants and does not prohibit the development of other trading systems or market innovation. The Commission believes that the SuperMontage is a reasonable effort by the NASD to enhance the quality of the Nasdaq market by providing more information to investors, promoting greater efficiency in executions, and increasing overall market transparency. While the SuperMontage will provide a central means for accessing liquidity in Nasdaq stocks, it does not represent an exclusive means, nor does it prevent broker-dealers from seeking alternative order routing and execution services. In addition, the Commission believes that the proposal should promote competition and capital formation by providing market makers and ECNs with several quote and order management options (*e.g.*, unattributable quotes and reserve size), and by providing ECNs and UTP Exchanges the ability to participate in the SuperMontage as either automatic execution participants or order delivery participants.[489]

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VI. Amendment No. 9

In Amendment No. 9, the NASD selected how preferenced orders would be processed. Under the Amendment, preferenced orders will be executed only if the preferenced Nasdaq Quoting Market Participant or UTP Exchange is at the BBO. This limitation ensures that customers will always receive executions at the BBO and should assist broker-dealers in fulfilling their best execution obligations. The Commission notes that those market participants wishing to access a Nasdaq Quoting Market Participant or UTP Exchange outside of the BBO may submit directed orders through the system or submit orders outside of Nasdaq (via private links or through ECNs).

The Commission finds that Amendment No. 9 is consistent with Section 15A (b)(6) of the Act,[490] which requires that the rules of an association be designed to promote just and equitable principles of trade and to remove impediments to and perfect the mechanism of a free and open market and a national market system. The Commission also finds good cause to

approve Amendment No. 9 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing of the amendment in the *Federal Register*. Specifically, Amendment No. 9 merely withdraws one alternative to the processing of preferenced orders, which was noticed in Amendment No. 8, and makes a technical correction to the definition of preferenced orders to make the definition conform with the description of how preferenced orders are processed against displayed quote/orders and reserve size, as well as represent that Nasdaq will not use OATS data to gain an unfair competitive advantage over other market participants. The Commission notes that in Amendment No. 8 the NASD specifically sought comment on two possible alternatives for processing preferenced orders with the clear intention of withdrawing one of the alternatives. Further, the Commission notes that the description in Amendment No. 8 made clear that preferenced orders would be processed against displayed quote/orders and reserve size. Accordingly, the Commission believes that there is good cause, consistent with Sections 15A (b)(6) and 19(b) of the Act[491] to approve Amendment No. 9 to the proposal on an accelerated basis.

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VII. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 9, including whether Amendment No. 9 is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR-NASD-99-53 and should be submitted by [insert 21 days from the date of publication].

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VIII. Conclusion

For the reasons discussed above, the Commission finds that the SuperMontage proposal, as amended, is consistent with the requirements of the Act (specifically, Sections 3, 11A, and 15A of the Act) and the rules and regulations thereunder applicable to a national securities association.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[492] that the SuperMontage proposal (SR-NASD-99-53), as amended, be and hereby is approved.

By the Commission.

Jonathan G. Katz

Secretary

Footnotes

1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 *See* letters from Thomas P. Moran, Assistant General Counsel, Office of the General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division of Market Regulation ("Division"), Commission, dated October 26, 1999 ("Amendment No. 1"); and from John F. Malitzis, Assistant General Counsel, Office of the General Counsel, Nasdaq, to Richard Strasser, Assistant Director, Division, Commission, dated October 29, 1999 ("Amendment No. 2").

4 *See* Securities Exchange Act Release No. 42166 (November 22, 1999), 64 FR 68125 (December 6, 1999) ("December 6, 1999 notice").

5 *See* letter from Richard G. Ketchum, President, NASD, to Belinda Blaine, Associate Director, Division, Commission, dated March 15, 2000 ("Amendment No. 3"). In Amendment No. 3, the NASD responded to comment letters and submitted substantive, clarifying, and technical amendments to the proposal. Other than the response to the comment letters, Amendment No. 3 was repeated in Amendment No. 4, which was published for comment in the *Federal Register*.

6 *See* letter from Richard G. Ketchum, President, NASD, to Belinda Blaine, Associate Director, Division, Commission, dated March 23, 2000 ("Amendment No. 4"). Among other things, in Amendment No. 4, the following aspects of the proposal were changed: (1) the order execution priorities of the system as they apply to electronic communications networks ("ECNs"), reserve size orders, and unlisted trading privilege exchanges ("UTP Exchanges"); (2) the five-second delay between price levels; and (3) the way odd-lots are processed.

7 *See* Securities Exchange Act Release No. 42573 (March 23, 2000), 65 FR 16981 (March 30, 2000).

8 *See* letter from Richard G. Ketchum, President, NASD, to Belinda Blaine, Associate Director, Division, Commission, dated May 16, 2000 ("Amendment No. 5"). Among other things, in Amendment No. 5, the NASD responded to comment letters received by the Commission in response to Amendment No. 4, submitted technical amendments to the proposed rule language, and provided a description of how the proposal would be implemented.

9 *See* letter from Richard G. Ketchum, President, NASD, to Belinda Blaine, Associate Director, Division, Commission, dated July 6, 2000 ("Amendment No. 6"). Generally, in Amendment No. 6, the NASD stated that it intends to implement the SuperMontage only after the planned conversion to decimals takes place. It also confirmed that it will allow market participants ample opportunity to prepare and test their internal systems before the start-up of the SuperMontage. The NASD further amended the SuperMontage proposal to provide reciprocity for UTP Exchanges that provide automatic executions against their quotes/orders. Also, the NASD clarified the order routing process and quote update feature for UTP Exchanges that take order delivery.

10 *See* letter from Richard G. Ketchum, President, NASD, to Annette Nazareth, Director, Division, Commission, dated August 7, 2000 ("Amendment No. 7"). Among other things, in Amendment No. 7, the NASD responded to comment

letters sent to the Commission by Bloomberg Tradebook, LLC and Instinet Corporation. As discussed below, the NASD amended the Order Execution Algorithm to provide that Nasdaq will rank orders from ECNs that charge a separate access fee on parity with orders from market makers and ECNs that do not charge a separate fee if the ECN notifies the NASD that the order offers price improvement that exceeds the access fee. Also, Nasdaq revised the directed order processing rules so that ECNs and market makers can elect to receive Liability Orders through the directed order process of the system.

11 *See* Securities Exchange Act Release No. 43133 (August 10, 2000), 65 FR 49842 (August 15, 2000).

12 *See* letter from Richard G. Ketchum, President, Nasdaq, to Belinda Blaine, Associate Director, Division, Commission, dated October 20, 2000 ("Amendment No. 8"). Generally, in Amendment No. 8, the NASD revised its Order Execution Algorithm to allow market participants that enter non-directed orders to interact with quotes/orders in the SuperMontage based on price/time priority, price/size/time priority, and price/time priority taking into account ECN access fees; created a new class of orders called preferenced orders; created a new data vendor data feed called NQDS Prime; clarified that the SuperMontage will identify parties entering orders; modified the time priority feature to preserve time priority when quotes are increased in size; modified the response time frames for order-delivery ECNs and UTP Exchanges; modified the SuperMontage so that all non-directed orders entered by order-entry firms are designated as "immediate or cancel" orders; and revised the definition of agency orders for UTP Exchanges. Amendment No. 8 also contained a summary, Exhibit 3, that incorporated and reconciled the original rule proposal and the subsequent proposed amendments.

13 *See* Securities Exchange Act Release No. 43514 (November 3, 2000), 65 FR 69084 (November 15, 2000).

14 *See* letter from Richard G. Ketchum, President, Nasdaq, to Robert L.D. Colby, Deputy Director, Division, Commission, dated January 8, 2001 ("Amendment No. 9"). In Amendment No. 9, the NASD withdrew Alternative A, regarding preferenced orders with no price restrictions, made a technical correction to its rule text to conform the definition of a preferenced order with the rule text describing the processing of such orders, and represented that Nasdaq will not use data received through the Order Audit Trail System ("OATS") to gain an unfair competitive advantage over other market participants, including another self-regulatory organization ("SRO") or broker/dealer (market maker or ECN).

15 A summary of the comment letters received by the Commission is available for public inspection in the Commission's Public Reference Room.

16 In addition, the Commission notes that the NASD withdrew a proposed rule change relating to an Integrated Order Delivery and Execution System ("IODES") on March 16, 2000 (SR-NASD-98-17).

17 As of the date of this Order, the Chicago Stock Exchange ("CHX") is the only active UTP Exchange.

18 NASD Rule 4613 requires a registered market maker to submit a two-sided quote (both bid and offer) that represents its proprietary trading interest and/or customer limit orders handled by the market maker. NASD Rule 4623 requires an ECN to submit the prices and sizes of orders at the highest buy price and lowest sell price entered into the ECN by market makers (and, in some cases, other subscribers). By agreement, UTP Exchanges must submit a two-sided quote that represents their market's best quote.

19 SOES was initially approved on a temporary basis in Securities Exchange Act Release No. 21567 (December 14, 1984), 50 FR 1662 (December 27, 1984). It was granted permanent approval in 1985. *See* Securities Exchange Act Release No. 21743 (February 12, 1985), 50 FR 7432 (February 22, 1985).

20 *See* Securities Exchange Act Release No. 25263 (January 11, 1988), 53 FR

1430 (January 19, 1988). *See also* Securities Exchange Act Release No. 25690 (May 11, 1988), 53 FR 17523 (May 17, 1988)(order granting permanent approval of SelectNet).

21 *See* Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1.

22 On January 14, 2000, the Commission approved an NASD rule change that allows Nasdaq to integrate the two systems to prevent most double liability situations. To date, the NASD has not implemented this change. *See* Securities Exchange Act Release No. 42344 (January 14, 2000), 65 FR 3987 (January 25, 2000) ("NNMS Order").

23 The Commission intends to give expeditious consideration to Nasdaq's application for registration and to similar applications from other markets, consistent with statutory requirements, in order to further competition and innovation among securities markets.

24 *See* letter from Joan C. Conley, Corporate Secretary, NASD, to Robert Colby, Deputy Director, Division, dated January 18, 2001.

25 UTP Exchanges may only enter a single principal quote/order. *See* Proposed NASD Rule 4710(f).

26 Non-liability orders are usually used to probe for undisplayed interest or to begin a negotiation.

27 Registered market makers must accept automatic executions (as they do currently under SOES). UTP Exchanges and ECNs may elect to accept automatic executions or delivery of the order.

28 ECNs that charge fees were permitted to indicate on any individual quote/order that the quote/order would provide price improvement exceeding the applicable fee, and such quote/orders would be given parity with quotes/orders that did not require payment of a separate fee.

29 Several ECNs have variable access fees that are different for subscribers and non-subscribers, and may depend on other factors, such as the volume of business.

30 *See* discussion at Section V.I.2, *infra*, regarding limitations on the NASD's ability to use its regulatory authority to preference or prejudice another market or market participants.

31 Any broker-dealer that does business with the public and is not a member of a registered national securities exchange must be a member of the NASD. *See* 15 U.S.C. 78*o*(b)(8).

32 *See* Rule 11Ac1-1(b)(1)(ii); 17 CFR 240.11Ac1-1(b)(1)(ii).

33 *See* discussion at Sections V.I.2 and 3, *infra.*

34 SOES was initially developed in 1984, and market maker participation was made mandatory in 1988.

35 *See* letter from Frank Zarb, Chairman and CEO, Nasdaq, to Senator Phil Gramm, dated October 24, 2000.

36 The UTP Plan is the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Exchange-Listed Nasdaq/National Market System Securities Traded on Exchanges on an Unlisted Trading Privileges Basis. *See also*, discussion at Section V.I.3, infra, regarding the need to revise the UTP Plan.

37 *See* S. Rep. No. 94-75, 94th Cong., 1 st Sess. 7 (1975) at p. 8 ("Senate Report").

38 *See* NNMS Order, *supra* note 22.

39 *See* NASD Rule 4613. While a market maker's quoted price and size is attributed to the market maker by the corresponding MMID, this may not

represent the market maker's best price if the market maker has placed a better-priced order with an ECN that complies with the display alternative under SEC Rules 11Ac1-1(c)(5) and 11Ac1-4. *See* 17 CFR 240.11Ac1-1(c)(5) and 17 CFR 240.11Ac1-4.

40 *See* NASD Rule 4623. ECNs also may be required to submit the prices and sizes of orders at the highest buy price and lowest sell price entered into the ECN by *all* subscribers to comply with Regulation ATS.

41 *See* Amendment No. 8, *supra* note 12. The NASD has stated that if Nasdaq should display more than three price levels in the NODF, it will provide expanded price level information through NQDS Prime. Nasdaq will assess a separate, additional vendor data fee for quote/order information away from the inside. The NASD will seek approval for the fee from the Commission in a separate filing.

42 According to the NASD, both attributable and non-attributable quotes/orders are considered "displayed orders" because they are displayed in the Nasdaq system.

43 UTP Exchanges will only be permitted to display principal quotes/orders on an attributable basis and agency quotes/orders on a non-attributable basis. *See* Proposed NASD Rule 4710(f). Further, UTP Exchanges will not be permitted to indicate a reserve size. *See* Proposed NASD Rule 4701(dd).

44 Nasdaq Level 1 Service provides the inside bid/offer quotations and identifies the market center at the best bid/best offer according to the Nasdaq UTP Plan. *See* NASD Rule 7010 and Nasdaq UTP Plan, Section VI, Paragraph C, Subparagraph 1. The National Quotation Data Service, or NQDS, provides individual market maker quotes, Level 1 Service, and last sale information. *See id.* According to the NASD, the SIZE MMID will be used in determining the best bid/best offer and corresponding market center for purposes of Level 1 and UTP.

45 *See* NNMS Order, *supra* note 22. Nasdaq also filed a proposal with the Commission that will permit the separate display of customer orders by market makers in Nasdaq through a market maker agency identification symbol. *See* Securities Exchange Act Release No. 41128 (March 2, 1999), 64 FR 12198 (March 11, 1999) (notice of filing of SR-NASD-99-09) ("Agency Quote Proposal"). The Commission subsequently extended the comment period for the Agency Quote Proposal. *See* Securities Exchange Act Release No. 41243 (April 1, 1999), 64 FR 17428 (April 9, 1999). The Agency Quote Proposal currently is pending with the Commission. If the Commission approves the Agency Quote Proposal, a market maker's Agency Quote could also have reserve size.

46 *See* Amendment No. 4, *supra* note 6. The displayed size of UTP principal quotes/orders will be executed after the reserve size of other participants has been accessed.

47 A UTP Exchange could only transmit a single bid quote/order or single offer quote/order for principal quotes/orders, but could send multiple quotes/orders for agency quotes/orders. *See* Proposed NASD Rule 4710(f).

48 Under the proposed rule change, a Liability Order is an order that Nasdaq believes gives rise to liability under the Firm Quote Rule, Exchange Act Rule 11Ac1-1, for a Nasdaq Quoting Market Participant or UTP Exchange. *See* 17 CFR 240-11Ac1-1.

49 *See* Amendment No. 8, *supra* note 12.

50 Under the proposal, UTP Exchanges cannot use the reserve size function, but may submit multiple non-attributable quotes representing agency interest.

51 *See* Amendment No. 8, *supra* note 12.

52 *See* NNMS Order, *supra* note 22.

53 *See* discussion in Section V.E., *infra*, for a description of the directed order

process.

54 Although Nasdaq eliminated the rule limiting the size of orders that may be entered into the NNMS, the system in the short term will only be able to deliver an execution up to 9,900 shares. However, if a market participant enters an order into the system that is eligible for automatic execution and exceeds the system size limit of 9,900, the OCF will break the order up into multiples of 9,900 shares. *See* NMMS Order, *supra* note 22.

55 *See* Amendment No. 8, *supra* note 12.

56 *See* Amendment No. 8, *supra* note 12.

57 *See* Amendment No. 7, *supra* note 10.

58 Because non-directed orders entered by order-entry firms will be designated as "immediate or cancel" orders, if a marketable limit order becomes non-marketable after entry into the system, Nasdaq will return the order (or the unexecuted portion thereof) to the entering party. *See* Amendment No. 8, *supra* note 12.

If an order is a sell short that is not exempt from NASD Rule 3350 and the market moves from an up-bid to a down-bid after the order has been entered but before delivery or execution, the system will return the order to the participant who entered it. Sell-short exempt orders (*i.e.*, those entered by primary market makers) may be entered into the system for execution.

59 Under the proposal, market makers will continue to be required to take automatic executions via the NNMS; however, ECNs and UTP Exchanges will have the option to participate in either the system's automatic execution or order delivery functions.

60 *See* Amendment No. 8, *supra* note 12.

61 UTP Exchanges cannot use the reserve size feature.

62 For example, assume there are three market participants at the inside bid of $20 and ECN1, ranked first for execution purposes, is displaying 1,000 shares at $20 on the bid side of the market, with 5,000 in reserve. Further assume that five market sell orders are entered into the system for the following amounts: (1) 100 shares; (2) 100 shares; (3) 100 shares; (4) 100 shares; (5) 700 shares. These market sell orders will be processed as follows. The first 100-share order will be delivered to ECN1, reducing its displayed size to 900. The second, third and fourth orders also will be delivered to ECN1, further reducing its displayed size to 600. When the fifth order is delivered to ECN1, its displayed size will be reduced to zero and the remaining 100 shares will access the displayed size of the next market participant in the queue at $20. *See* Amendment No. 7, *supra* note 10. Nasdaq will not wait for an order to be processed before routing another order to an ECN. *See* Amendment No. 8, *supra* note 12.

63 *See* Amendment No. 8, *supra* note 12.

64 *See* Amendment No. 8, *supra* note 12.

65 *See* Amendment No. 8, *supra* note 12.

66 *See* NNMS Order, *supra* note 22.

67 *See* discussion of current SOESed-out-of-the-Box procedure at Section V.C., *infra* and Proposed Amended NASD Rule 4613(a).

69 According to the NASD, similar to the Intermarket Trading System ("ITS"), the SuperMontage will generally attempt to probe and sweep the Nasdaq market before sending an order to another market center. *See, e.g.*, Section 8(a)(v) of the ITS Plan.

70 The algorithm is similar to the algorithm proposed in Amendment No. 7. *See*

Amendment No. 7, *supra* note 10. .

71 In Amendment No. 6, *supra* note 9, the NASD represented that if, in a decimals environment, ECNs changed the manner in which they charge fees to reflect their fees in their published quote, these ECN quotes will be given the same priority for non-directed orders as market makers and non-attributable agency quotes of UTP Exchanges.

72 Orders will be processed in time sequence. Thus, if an order is in interval delay because it meets the above parameters, orders that are behind the interval-delay order will be held in the queue.

73 For example, assume that at 10:00:01 a.m., the inside market in Stock G is $104.55 to $104.60, and the following quotes/orders are being displayed in the system on the bid side of the market:

MMA $104.55 - 1,000 (total, including reserve)

MMB $104.50 - 2,000 (total, including reserve)

ECN1 $104.45 - 9,000 (total, including reserve)

MMC $104.45 - 10,000 (total, including reserve)

At 10:00:02 a.m., Institution Q enters a 10,000 share market sell order (through a market maker), which is designated as a Sweep Order. Since the order will be filled in full by the interest that is at the three price levels being displayed in Nasdaq, Institution Q's order is filled in full with no time delay between prices. If at 10:00:02 a.m., while the Sweep Order is executing against the quotes/orders in Nasdaq, an internal subscriber of ECN1 (an automatic execution ECN) wishes to execute against the $104.45 for 9,000 shares being displayed in Nasdaq, before filling the subscriber's order, ECN1 could send a request to cancel the order to Nasdaq. If Nasdaq had already executed against the 9,000 shares, ECN1 would send a message to its customer declining the execution because the Sweep Order had filled the quote/order. If Nasdaq had not executed against the 9,000 shares, ECN1's request to cancel would be granted, the internal execution could occur, and the remainder of Institution Q's order would be executed against MMC. *See* Amendment No. 5, *supra* note 8.

74 *See* Exchange Act Rule 11Ac1-1, 17 CFR 240.11Ac1-1.

75 *See* Proposed NASD Rule 4710(b)(3).

76 *See* Amendment No. 7, *supra* note 10.

77 According to the NASD, prior to the opening, Nasdaq will process "trade-or-move" messages in accordance with NASD Rule 4613, as amended by File Nos. SR-NASD-99-23 and SR-NASD-00-18. *See* Securities Exchange Act Release Nos. 42400 (February 7, 2000), 65 FR 7407 (February 14, 2000); and 42896 (June 2, 2000), 65 FR 36747 (June 9, 2000).

78 *See* Amendment Nos. 4 and 6, *supra* notes 6 and 9.

79 *See* Amendment No. 6, *supra* note 9. As a result, market makers may have to develop separate systems to accept order delivery from UTP Exchanges.

80 *See* Proposed NASD Rule 4710(f).

81 *See* Amendment Nos. 4 and 8, *supra* notes 6 and 12.

84 *See* Amendment No. 6, *supra* note 9.

85 *See* December 6, 1999 notice, *supra* note 4, and Comment Summary for a complete description of these comments. The Commission notes that several commenters addressed the NNMS, which was pending at the time that the

NASD submitted this proposed rule change. The Commission is not addressing these comments because the Commission has already approved the NNMS. *See* NNMS Order, *supra* note 22. The Commission also notes that several commenters raised issues with respect to the Agency Quote proposal currently pending before the Commission. The Commission will address those comments when it considers the Agency Quote proposal. If the Agency Quote proposal is not approved by the Commission, Nasdaq has represented that it will file conforming rule changes to eliminate references to Agency Quotes in its rule text. *See* Amendment No. 3, note 8, *supra* note 5. At least one commenter also questioned the application of the proposal with respect to the IODES proposal. Nasdaq, however, has withdrawn this proposal. *See supra* note 16. Other comments not directly related to the SuperMontage are also not addressed in this Order.

86 *See* Electronic Traders Association Letter ("ETA" Letter); Investment Company Institute Letter ("ICI" Letter); Security Traders Association Letter ("STA" Letter); Security Traders Association of New York, Inc. Letter ("STANY" Letter); Merrill Lynch Letter; Chicago Stock Exchange Letter ("CHX" Letter); Morgan Stanley Dean Witter Letter ("MSDW" Letter); Goldman Sachs Letter; Nasdaq Institutional Advisory Council Letter ("ITAC" Letter); and ITG Letter.

87 *See* Bloomberg Letter; Automated Trading Desk Letter ("ATD" Letter); Instinet Letter; Island Letter (Initially, Island did not explicitly approve of or oppose the proposed rule change. Island recommended that the Commission delay consideration of the proposed rule "until such time as the Nasdaq market is restructured to ensure fair competition between Nasdaq and ECNs or until such time as the Commission has permitted ECNs such as Island to become registered national securities exchanges." However, in its comment letter responding to Amendment No. 4, Island expressed its opposition to the proposal); and NexTrade Letter.

88 *See* BNY ESI & Co. Letter ("BNY" Letter); Bancorp Letter; Heartland Letter (Heartland believed that the proposed rule change should not be approved until the SOES/SelectNet Integration is used and tested); American Century Investment Management Letter ("ACIM" Letter); Salomon Smith Barney Letter; and Mount Pleasant Brokerage Services Letter ("MPBS" Letter).

89 *See* ETA Letter; ICI Letter; STA Letter; STANY Letter; Merrill Lynch Letter; MSDW Letter; ITAC Letter; CHX Letter; Goldman Sachs Letter; and ITG Letter.

90 *See* Securities Exchange Act Release No. 42573, *supra* note 7.

91 *See* Instinet Letter; ICI Letter; Bloomberg Letter; CHX Letter; Joseph J. Burrello, Principal and Manager of Nasdaq Trading, William Blair & Company, Larry Elmore, Partner and Manager of Equity Trading, J.C. Bradford & Co., Dennis A. Green, Senior Vice President and Manager of Nasdaq Trading, Legg Mason Wood Walker, Inc., Jack Hughes, First Vice President and Manager of Equity Trading, Janney Montgomery Scott, LLC, Robert Krohn, Managing Director of Nasdaq Trading, McDonald Investments, Inc., Greg Lemaster, Manager of Nasdaq Trading, Stifel, Nicolaus & Company, Inc., James R. Miller, Manager of Nasdaq Trading, Robert W. Baird & Company, Inc., Bobby Olsen, Vice President and Manager of Nasdaq Trading, Advest, Inc., Gerard Yurasits, Senior Nasdaq Trader, First Albany Corporation, Hedi H. Reynolds, Managing Director of Nasdaq Trading, Morgan, Keegan & Company, Inc., William Cahill, Managing Director of Nasdaq Trading, Robinson Humphrey Letter ("Traders" Letter); Island Letter; Archipelago Letter; Granite Financial Letter; Security Investment Company Letters; Charles Schwab Letter (addressed to Senator Phil Gramm); Telemet Letter; Congressman Drier Letter; Congressman Pallone Letter; Congressman Dingell Letter; Congresswoman Morella Letter; Congressman Stupak Letter; Congresswoman Wilson Letter; Congressman Radanovich Letter; Congressman Towns Letter; Congressman McInnis Letter; Congressman Thomas Letter; Spears, Leeds & Kellogg Letter (addressed to Senator Phil Gramm); First Union Letter (addressed to Alfred R. Berkeley, President, the Nasdaq Stock Market); Seidel Letter ("Seidel" Letter); Thurston, Springer,

Miller, Herd & Titak Letter ("Titak" Letter); Philadelphia Corporation for Investment Services Letter ("Philadelphia Corp." Letter)(address to Senator Arlen Spector); and Robert Bannon Letter ("Bannon" Letter).

The Commission notes that commenters did not limit their discussion to the topics addressed in Amendment No. 4. Rather, many commenters discussed the proposal in its entirety. These commenters are listed as responding to Amendment No. 4 because their letters were dated after Amendment No. 4 was published.

92 *See* ICI Letter; CHX Letter; Traders Letter; Charles Schwab Letter; Congressman Drier Letter; Congressman Pallone Letter; Congresswoman Morella Letter; Congressman Stupak Letter; Congresswoman Wilson Letter; Congressman Towns Letter; Congressman McInnis Letter; Congressman Thomas Letter; Congressman Radanovich Letter; Titak Letter; Philadelphia Corp. Letter; Spears, Leeds & Kellogg Letter; First Union Letter; Security Investment Company Letters; Seidel Letter; and Bannon Letter.

93 *See* Instinet Letter; Bloomberg Letter; Archipelago Letter; Granite Financial Letter; and Island Letter.

94 *See* Congressman Dingell Letter; and Telemet Letter.

95 *See* ICI Letter; Traders Letter; and Bannon Letter.

96 *See* Securities Exchange Release No. 43133, *supra* note 11.

97 The Commission notes that commenters did not limit their discussion to the topics addressed in Amendment Nos. 5, 6, and 7. Rather, many commenters discussed the proposal in its entirety. These commenters are listed as responding to Amendment Nos. 5, 6 and 7 because their letters were dated after Amendment No. 7 was published.

98 *See* Senator Schumer Letter; Congressman Ehrlich Letter; Congressman Shays Letter; Congressman Fossella Letter; Starbucks Coffee Letter ("Starbucks" Letter)(addressed to Congresswoman Jennifer Dunn); STA Letter; Association of Publicly Traded Companies Letter ("APTC" Letter); American Shareholder's Association Letter ("ASA" Letter); Consumer Federation of America Letter ("CFA" Letter); Wendell Garrett Letter ("Garrett" Letter) (addressed to Congressman John Shadegg and Senator Jon Kyl); O'Connor Letter; and Jeffries Letter.

99 *See* Philadelphia Stock Exchange Letter ("Phlx" Letter); ACIM Letter; Instinet Letter; Bloomberg Letter; BRUT Letter; Harold Bradley Letter ("Bradley" Letter); Archipelago Letter; NexTrade Letter; Seema Aurora Letter ("Aurora" Letter); Island Letter; Renaissance Letter; Leon Letter; and Kupfer Letter.

100 *See* T. Rowe Price Associates, Inc. Letter ("TRPC" Letter); Gramm Letter; and Scudder Kemper Investments Letter ("Scudder Kemper" Letter).

101 *See* Securities Exchange Act Release No. 43514, *supra* note 13.

102 *See* Bloomberg Letter.

103 *See* Instinet Letter (Instinet also submitted a letter addressing changes to be made by Amendment No. 8 prior to the Commission's receipt of the Amendment. This letter has also been incorporated); Archipelago Letter; Letter from American Century Investment Management, Inc., Janus Capital Corporation, Neptune Capital Management LLC, State Farm Mutual Automobile Insurance Company, Alex Brown Investment Management, LP, Boston Company, Wachovia Bank, NA, State Street Research & Management Co., Banc One Investment Advisors Corporation, West Highland Capital, Inc., Fidelity Trust Company, GMG/Seneca Capital Management, Westchester Capital Management, Inc., Becker Capital Management, Inc., Greenville Capital Management, Inc., Friess Associates of Delaware, Inc., C.E. Unterberg, Tobin Advisors, LP, Kepmen Capital, Schroder Investment Management Ltd., Foreign & Colonial Management, Ltd., RAS Asset Management SGR, Scudder Investor Services, Inc., New York State Common

Retirement Fund, Dreyfus Fund, Virginia Retirement System, Pennsylvania School Employee Retirement Systems, Harris Associates Securities, LP, Columbia Partners, LLC Investment Management, Caterpillar Investment Management, Ltd., Nicholas Applegate Capital Management, Inc., Symphony Asset Management, Monetta Financial Services, Inc., Buckingham Capital Management, Sedacca Capital Management, Inc., Robeco Group NV, Montag & Caldwell, Gemini Management Partners, LLC, Abu Dhabi Investment Authority, BT&T Asset Management AG, Jacobs Levy Equity Management, Inc., Newton Investment Management Ltd., Berliner Freiverkehrs (Aktien) AG, Compass Capital Ltd., SAC Capital, Standish, Ayer & Wood, Minnesota Power and Light Co., Frontier Capital Management, Sage Asset Management, LLC, Target Holdings Corporation, Lincoln Partners, Apex Capital, LLC, Twin Capital Management, Kanaly Trust Company, Rothschild Bank AG, Sanpaolo IMI Asset Management SGR, Banque Paribas Luxembourg, Golden Capital Management, Investment Adviser, Inc., R.H. Capital Associates, Quaker Capital Management, Eagle and Dominion Asset Management Ltd., Bank Invest, Morley Fund Management, Provident Investment Counsel, Gruber & McBaine Capital Management, Dupont Capital Management, Masters Capital Investments, LLC, Sawgrass Asset Management, LLC, Kaintuck Capital Management, LP, HighMark Capital Management, Inc., Atticus Holdings, LLC, Credit Agricole Indosuez Cheuvreux, Royce & Associates, Inc., OrbiMed Advisors LLC, Cordillera Asset Management, Inc., Fisher Investments, Inc., Ohio Valley Management, Inc., Loews Corporation, National City Investment Company, Zak Capital, Inc., Ocean Park Capital Management, LLC, Tattersall Advisory Group, Peninsula Capital Management, Westway Capital, LLC, Munder Capital Management, Kadem Capital, LLC, Phoenix Zweig Advisers, Fuller & Thaler Asset Management, Chicago Equity Partners, LLC, Amerindo Advisers, Ltd., Group Aesop Capital Partners, LLC, Wilen Management Corporation, Ballentine Capital Management, Inc., Summit Capital Management LLC, Sirach Capital Management LLC, Cadwell and Orkin, Wentworth, Hauser & Violich, Inc., Matrix Asset Advisors, Inc., George Weiss Associates ("Investment Companies Letter")(addressed to Senator Phil Gramm); CFA Letter; Office of the Comptroller, State of New York ("NY" Letter) (stating that SuperMontage could ideally increase information, but may provide unfair advantages to market makers); and Adriaanse Letter ("Adriaanse Letter").

104 *See* Security Investment Company Letter; ICI Letter; STA Letter; Pershing Trading Company, L.P. ("Pershing" Letter); ACIM Letter; Cincinnati Stock Exchange ("CSE" Letter); Scudder Kemper Letter; and Vanguard Letter.

105 *See* Island Letter; BRUT Letter; Ryley Letter; CHX Letter; Suss Letter ("Suss Letter"); Silverman Letter ("Silverman Letter"); Erfort Letter ("Erfort Letter"); Birmingham Letter ("Birmingham Letter") and aLV Letter ("aLV Letter") (urging Commission to re-think passing the SuperMontage in its current form).

106 15 U.S.C. 78*o*-3(b)(6), (9), and (11), and 15 U.S.C. 78k-1(a)(1)(C).

107 15 U.S.C. 78*o*-3(b)(6).

108 15 U.S.C. 78*o*-3(b)(9).

109 15 U.S.C. 78*o*-3(b)(11).

110 15 U.S.C. 78k-1(a)(1)(C).

111 *See* ETA Letter; Merrill Lynch Letter; Goldman Sachs Letter; MSDW Letter; STA Letter; STANY Letter; ITAC Letter; ICI Letter; Bannon Letter; Bancorp Letter; Charles Schwab Letter; Congressman Drier Letter; Congressman Pallone Letter; Congresswoman Morella Letter; Congressman Stupak Letter; Congresswoman Wilson Letter; Congressman Towns Letter; Congressman McInnis Letter; Congressman Thomas Letter; Spear, Leeds & Kellogg Letter; First Union Letter; Seidel Letter; Security Investment Company Letters; ITG Letter; APTC Letter; Jeffries Letter; Senator Schumer Letter; Congressman Radanovich Letter; Congressman Shays Letter; Congressman Fossella Letter; Titak Letter; ASA Letter; Starbucks Letter; Philadelphia Corp. Letter; Garrett

Letter; NY Letter; and Congressman Ehrlich Letter.

112 *See* ICI Letter.

113 *See* MSDW Letter.

114 *See* TRPA Letter.

115 *See* ETA Letter; Merrill Lynch Letter; Goldman Sachs Letter; STA Letter; STANY Letter; ITAC Letter; ICI Letter; Bannon Letter; Bancorp Letter; MSDW Letter; Charles Schwab Letter; Congressman Drier Letter; Congressman Pallone Letter; Congresswoman Morella Letter; Congressman Stupak Letter; Congresswoman Wilson Letter; Congressman Towns Letter; Congressman McInnis Letter; Congressman Thomas Letter; Spears, Leeds & Kellogg Letter; First Union Letter; Seidel Letter; Security Investment Company Letters; ITG Letter; APTC Letter; Senator Schumer Letter; Congressman Radanovich Letter; Congressman Shays Letter; Congressman Fossella Letter; Titak Letter; ASA Letter; Starbucks Letter; Philadelphia Corp. Letter; Jeffries Letter; Garrett Letter; NY Letter; and Congressman Ehrlich Letter.

116 *See* ITAC Letter; Congressman Fossella Letter; APTC Letter; and Charles Schwab Letter; *see also* Bannon Letter and Island Letter.

117 *See* ITAC Letter.

118 *See* Bannon Letter; *see also* Senator Schumer Letter.

119 *See* MSDW Letter.

120 *See* Bloomberg Letter and NexTrade Letter.

121 *See* Bloomberg Letter.

122 *See* Bloomberg Letter.

123 *See* Archipelago Letter.

124 *See* Archipelago Letter.

125 *See* NexTrade Letter.

126 *See* CFA Letter.

127 *See* CFA Letter.

128 *See* ICI Letter and ACIM Letter; *see also* ITAC Letter.

129 *See* ACIM Letter.

130 *See* Bloomberg Letter.

131 15 U.S.C. 78*o*-3(b)(6), (b)(11).

132 15 U.S.C. 78k-1(a)(1)(B), -(a)(1)(C).

133 15 U.S.C. 78k-1(a)(1)(B).

134 UTP Exchanges will be permitted only to send a single bid and a single offer for principal orders/quotes, but may submit multiple agency quotes/orders. *See* Proposed NASD Rule 4710(f).

135 As discussed in Section III.K, *supra*, the SuperMontage will not be implemented until after decimals in the Spring of 2001. In a recent study, SRI Consulting found that with smaller minimum pricing increments, liquidity may be dispersed as limit orders are spread over smaller price intervals. *See* SRI Consulting, Assessing the Impact on Message Traffic of Trading Equities and Option in Decimal Increments (Executive Summary at p. 31)(April 16, 1999). Therefore, market participants may want to see more price levels away from the BBO.

136 *See* Amendment No. 8, *supra* 12. At least one commenter supported the addition of NQDS Prime. *See* STA Letter.

137 *See* December 6, 1999 notice, *supra* note 4.

138 *See* ATD Letter.

139 *See* Bloomberg Letter.

140 *See* Bloomberg Letter.

141 *See* Bloomberg Letter.

142 *See* Bloomberg Letter.

143 *See* Bloomberg Letter.

144 *See* Island Letter.

145 *See* Island Letter.

146 *See* Island Letter.

147 *See* Amendment No. 8, *supra* note 12.

148 *See* Amendment No. 8, *supra* note 12.

149 *See* STA Letter and Pershing Letter.

150 *See* STA Letter.

151 *See* 17 CFR 240.11Ac1-1(c)(5).

152 Market makers must display the full size of customer limit orders in some circumstances pursuant to the Commission's Order Handling Rules.

153 *See* ITG Letter; ITAC Letter; and First Union Letter.

154 *See* ITG Letter

155 *See* ITAC Letter.

156 *See* Goldman Sachs Letter.

157 *See* Amendment No. 4, *supra* note 6.

158 *Id.* Originally, the NASD proposed that non-directed orders be processed pursuant to one algorithm. In Amendment No. 8, the NASD proposed to offer market participants three algorithms from which to choose. *See* Amendment No. 8, *supra* note 12.

159 *See* ICI Letter.

160 *See* ICI Letter.

161 *See* Traders Letter.

162 *See* Amendment No. 7, *supra* note 10.

163 *See* Amendment No. 8, *supra* 12.

164 *See* Proposed NASD Rules 4710(b)(1)(B); 4710(b)(2); 4701(y), and 4701(t).

165 A UTP Exchange may transmit only a single bid or single offer for principal quotes/orders, but may send multiple agency quotes/orders. *See* Proposed NASD Rule 4710(f).

166 166 *See* Proposed NASD Rule 4701(u).

167 *See* Amendment 6, *supra* note 9.

168 15 U.S.C. 78*o*-3(b)(6).

169 15 U.S.C. 78k-1(a)(1)(C)(i).

170 Currently, Nasdaq can only handle orders up to 9,900 shares. However, if a market participant enters an order for automatic execution that exceeds 9,900 shares, the OCF will break the order up into multiples of 9,900 shares and execute the orders.

171 *See* MPBS Letter; ITG Letter; ETA Letter; CHX Letter; and ATD Letter.

172 *See* ITG Letter; *see also* MPBS Letter.

173 *See* ATD Letter.

174 Several ECNs believe that the automatic execution feature of the OCF, among other things, is anti-competitive. These comments are discussed in Section V.I, *infra*.

175 *See* Archipelago Letter (citing Exchange Act Rule 11Ac1-1(b)(1)(i)).

176 *See* Amendment No. 8, *supra* note 12.

177 *See* ETA Letter.

178 *See* ETA Letter and MSDW Letter.

179 *See* ETA Letter. The Commission notes that NASD IM 4613 bans automated quote updates or tracking of *inside quotations* in Nasdaq subject to two exceptions. The Commission notes that the revised SOESed -Out-of-the-Box procedures are not related to the inside market.

180 *See* Island Letter.

181 *See* Bloomberg Letter; ACIM Letter; Merrill Lynch Letter; Instinet Letter; NexTrade Letter; and CHX Letter. One commenter believed that by ranking customer orders by the status of the delivering broker, the Order Execution Algorithm impedes efficient order interaction. *See* ACIM Letter.

182 *See* Instinet Letter; Bloomberg Letter; and NexTrade Letter. Instinet suggested that the inferior priority of order delivery participants will (1) impair the ability of participants to obtain best execution for their customers; and (2) improperly influence investors' choices of trading venues and inhibit the interaction of pools of liquidity.

183 *See* Amendment No. 4, *supra* note 6.

184 For a discussion of how ECNs are treated under the Order Execution Algorithms, *see* Section V.D.3, *infra*. One commenter expressed support for the Order Execution Algorithm's basic foundation, execution of orders based on price/time priority, stating that this would encourage competition. *See* Bannon Letter.

185 These comments are discussed in detail in Section V.D.3.a, *infra*.

186 *See* Amendment No. 7, *supra* note 10.

187 *See* Amendment Nos. 4 and 7, *supra* notes 6 and 10. The SuperMontage would have initially executed non-directed orders of Nasdaq Quoting Market Participants against their own quotes/orders that are at the BBO.

188 *See* BRUT Letter; Instinet Letter; ACIM Letter; Bradley Letter; Archipelago Letter; Phlx Letter; Scudder Kemper Letter; CFA Letter; and Bloomberg Letter. These comments are discussed in detail in Section V.D.3, *infra*.

189 *See* ACIM Letter; Archipelago Letter; TRPA Letter; and Scudder Kemper Letter.

190 *See* Archipelago Letter.

191 *See* TRPA Letter.

192 *See* Amendment No. 8, *supra* note 12.

193 Market makers and ECNs will not lose time priority for updating trading interest to display greater size. Proposed NASD Rule 4707(a)(2).

194 *See* Section V.D.2, *infra*, for a discussion of preferenced orders.

195 *See* CHX Letter. *See also*, discussion at Section V.D.4 regarding the commenter's concerns regarding the treatment of UTP Exchanges.

196 *See* ICI Letter. This commenter also supported maintaining time priority when a market participant increases its displayed size. *See also* CFA Letter (supporting price/time default algorithm).

197 *See* CFA Letter; Investment Companies Letter; and NY Letter; *see also* Scudder Kemper Letter; Adriaanse Letter; and Silverman Letter.

198 *See* Investment Companies Letter.

199 *See* STA Letter; *see also* Pershing Letter.

200 *See* Vanguard Letter and Instinet Letter.

201 *See* Vanguard Letter; Security Investment Company Letters; ICI Letter; and NY Letter; *see also* Scudder Kemper Letter.

202 *See* ICI Letter; ACIM Letter; Scudder Kemper Letter; Suss Letter; Birmingham Letter; Adriaanse Letter; and Vanguard Letter.

203 *See* ICI Letter and Vanguard Letter. *See also* Adriaanse Letter.

204 *See* ICI Letter; *see also* Vanguard Letter.

205 *See* ICI Letter.

206 *See* ACIM Letter.

207 *See* Scudder Kemper Letter.

208 15 U.S.C. 78*o*-3(b)(6).

209 15 U.S.C. 78k-1.

210 *See* discussion in Section V.D.3.a, *infra*.

211 *See* Instinet Letter.

212 *See* STA Letter; MSDW Letter; and STANY Letter.

213 *See* STA Letter; MSDW Letter; and STANY Letter.

214 *See* STANY Letter.

215 *See* ICI Letter; Instinet Letter; CFA Letter; Bloomberg Letter; and ACIM Letter.

216 *See* ICI Letter; *see also* Scudder Kemper Letter.

217 *See* ACIM Letter; and CFA Letter.

218 *See* ACIM Letter; *see also* Scudder Kemper Letter.

219 *See* ACIM Letter; *see also* Bradley Letter.

220 *See* Instinet Letter; *see also* Bloomberg Letter and Bradley Letter.

221 *See* Securities Exchange Act Release No. 42450 (February 23, 2000), 65 FR 10577 (February 28, 2000). In September 1999, for example, there was an average of 11.4 market makers per Nasdaq issue. NASD, <http://www.marketdata.nasdaq.com> (visited December 11, 1999). There was an average of 47.5 market makers in the top 1% of issues by daily dollar trading volume, 24.0 market makers in the next 9% of issues, and 4.9 market makers in the bottom 10% of issues. *Id.*

222 According to the NASD, only 26% of the share volume and 36% of trades in Nasdaq are executed using SOES or SelectNet. *See* e-mail to William Atkinson, Office of Economic Analysis, Commission, from Michael Edleson, Senior Vice President, Chief Economist, NASD, dated August 18, 2000.

223 *See* Securities Exchange Act Release No. 42450 at notes 48 and 49 and accompanying text, *supra* note 221; *see also* Securities Exchange Act Release No. 35751 (May 22, 1995), 60 FR 27997 (May 26, 1995) ("Manning II") (prohibiting market makers from trading ahead of their customer limit orders in Nasdaq securities).

224 *See* Bloomberg Letter.

225 *See* Amendment No. 8, *supra* note 12.

226 *See* CHX Letter and STA Letter.

227 *See* Bloomberg Letter.

228 *See* Instinet Letter; ACIM Letter; CSE Letter; Scudder Kemper Letter; and NY Letter.

229 *See* Amendment No. 9, *supra* note 14. .

230 *See* Instinet Letter; NY Letter; CFA Letter; ICI Letter; Investment Companies Letter; ACIM Letter; Birmingham Letter; Adriaanse Letter; and Vanguard Letter.

231 *See* Instinet Letter; NY Letter; *see also* Investment Companies Letter; Adriaanse Letter; and Vanguard Letter.

232 *See* CFA Letter and ICI Letter.

233 *See* Vanguard Letter.

234 The Commission notes that a Nasdaq Quoting Market Participant or UTP Exchange may elect not to take a directed order on a Liability Order basis. *See* Proposed NASD Rule 4710(c).

235 Market makers are prohibited from charging access fees under the Firm Quote Rule. *See* Exchange Act Rule 11Ac1-1.

236 The NASD's original proposal gave priority to participants that accepted automatic execution over those that accepted order delivery. In response to commenters, in Amendment Nos. 3 and 4, the NASD amended the Order Execution Algorithm. One commenter stated that the amended Order Execution Algorithm offered "some improvement," but it was still discriminatory because UTP Exchanges would be executed behind market makers. *See* Bloomberg Letter.

237 *See* Amendment No. 4, *supra* note 6.

238 *See* CHX Letter; Bannon Letter; Instinet Letter; Archipelago Letter; Bloomberg Letter; and Island Letter.

239 *See* CHX Letter and Bannon Letter.

240 *See* Bannon Letter.

241 *See* ITG Letter.

See Instinet Letter; Bloomberg Letter; Archipelago Letter; and Island Letter.

242

243 *See* Instinet Letter.

244 *See* Island Letter.

245 *See* Amendment No. 7, *supra* note 10.

246 *See* Amendment No. 6, *supra* note 9.

247 *Id.*

248 *See* Instinet Letter, ACIM Letter, BRUT Letter; Scudder Kemper Letter; Bradley Letter; Archipelago Letter; CFA Letter; and Bloomberg Letter.

249 *See* Scudder Kemper Letter.

250 *See* Scudder Kemper Letter.

251 *See* Bloomberg Letter.

252 *See* Bloomberg Letter.

253 *See* Archipelago Letter.

254 *See* Archipelago Letter (see examples provided in footnote 11).

255 *See* Instinet Letter and ACIM Letter.

256 *See* Instinet Letter.

257 *See* BRUT Letter.

258 *See* ACIM Letter.

259 *See* BRUT Letter.

260 *See* BRUT Letter.

261 *See* CFA Letter.

262 *See* CFA Letter.

263 *See* CFA Letter.

264 *See* Bloomberg Letter; Instinet Letter; Scudder Kemper Letter; and TRPA Letter.

265 *See* Bloomberg Letter and Instinet Letter.

266 *See* Bloomberg Letter and Instinet Letter.

267 *See* Amendment No. 8, *supra* note 12. Under the prior proposal, if a market participant chose to give Nasdaq a quote instead of *order* detail, the market participant would have lost time priority to its quote when it added to size. At least one commenter supported this change. *See* STA Letter.

268 *See* Instinet Letter; *see also* CFA Letter and NY Letter.

269 *See* Island Letter.

270 *See* Island Letter.

271 *See* Island Letter; *see also* CFA Letter.

272 *See* Instinet Letter; Suss Letter; Birmingham Letter; and Adriaanse Letter; and CFA Letter.

273 15 U.S.C. 78*o*(b)(6).

274 Moreover, trades in ITS between markets are not subject to market fees, even though these markets charge fees to their members for executing trades on that market. *See* Securities Exchange Act Release No. 42536 (March 16, 2000), 65 FR 15401 (March 22, 2000).

275 While, today, ECN fees are small in relation to the existing quotation increment of 1/16, with the coming of decimal pricing the significance of ECN fees in comparison to the minimum quotation increment could become much greater.

276 Currently, ECN public quotes are rounded away to the next 1/16 th price when the ECN's best internal price is at a fraction smaller than 1/16 th (the current minimum Nasdaq quote increment).

277 Even if the SuperMontage were to include an identifier flagging ECN price improvement, as some commenters suggest, the *amount* of that price improvement would remain unknown, and could in fact be trivial, whereas the fee charged is known to a participant.

278 In a decimals environment, Nasdaq's minimum quoting increment may be a penny.

279 The Commission notes that quoting in subpennies raises other issues, such as capacity and trading issues, not related to the SuperMontage. These issues will need to be addressed marketwide. *See* Securities Exchange Act Release No. 42914 (June 8, 2000), 65 FR 38010 (June 19, 2000) (ordering the implementation of decimal pricing). In the Commission's order requiring the implementation of decimals, the Commission called for a study regarding the impact of decimal pricing on systems capacity, liquidity, and trading behavior, including an analysis of whether there should be a uniform minimum increment for a security.

280 15 U.S.C. 78*o*-3(b)(6).

281 Nasdaq subsequently clarified that it will add two seconds for "processing time," and therefore, the time to respond would actually be seven seconds. *See* letter from Richard G. Ketchum, President, NASD, to Annette Nazareth, Director, Division, Commission, dated July 18, 2000.

282 *See* Instinet Letter and Bloomberg Letter.

283 *See* Instinet Letter.

284 *See* ACIM Letter.

285 *See* Bloomberg Letter.

286 *See* Amendment No. 8, *supra* note 12.

287 *See* CHX Letter.

288 *See* STA Letter.

289 *See* Instinet Letter.

290 *See* Securities Exchange Act Release No. 42847 (May 26, 2000), 65 FR 35690 (June 5, 2000) (noticing a proposed rule change by the NASD to include UTP Exchanges in the NNMS).

291 *See* Island Letter.

292 In SuperMontage, an order that has exited the Nasdaq system and is en route to an ECN or UTP Exchange cannot be canceled. Thus, if a market participant requests to cancel an order, the system will hold the cancel request until the ECN or UTP Exchange completes interacting with the delivered order (i.e., the ECN or UTP Exchange executes, partially executes, or declines the order) or fails to respond within the allowable time.

293 *See* Amendment No. 5, *supra* note 8.

294 *See* Merrill Lynch Letter; MSDW Letter; and Goldman Sachs.

295 *See* Goldman Sachs Letter; and MSDW Letter.

296 *See* Merrill Lynch Letter.

297 *See* Merrill Lynch Letter.

298 *See* Merrill Lynch Letter.

299 *See* NexTrade Letter and Bloomberg Letter; *see also* Instinet Letter.

300 *See* Instinet Letter.

301 *See* Amendment Nos. 7 and 8, *supra* notes 10 and 12.

302 *See* Amendment No. 4, *supra* note 6.

303 *See* Archipelago Letter. *See also* CHX Letter; CSE Letter; and Section V.G., *infra*.

304 *See* Phlx Letter.

305 *See* CSE Letter and Phlx Letter.

306 *See* Phlx Letter.

307 *See* CSE Letter and Phlx Letter.

308 *See* CSE Letter.

309 *See* CHX Letter and CSE Letter.

310 *See* CHX Letter.

311 *See* CSE Letter.

312 *See* CHX Letter and CSE Letter.

313 *See* Section 8(a)(v) of the ITS Plan.

314 The Commission notes that the NASD is currently negotiating with at least one UTP Exchange. The Commission expects that the UTP Plan will be amended, if needed, to reflect changes provided for in this proposal.

315 *See* Amendment No. 4, *supra* note 6.

316 *See* ETA Letter and ICI Letter.

317 *See* STA Letter; STANY Letter; Salomon Smith Barney Letter; and Merrill Lynch Letter.

318 *See* ETA Letter and STANY Letter; *see also* ACIM Letter.

319 *See* ETA Letter.

320 *See* ETA Letter.

321 *See* Amendment No. 4, *supra* note 6.

322 *See* ICI Letter.

323 *See* ICI Letter.

324 15 U.S.C. 78*o*-3(b)(6) and 15 U.S.C. 78k-1.

325 Although one commenter was concerned that the five-second interval delay would allow a market participant to decline an execution at its published quote, the Commission notes that market makers will still be subject to

automatic execution and therefore, will not be able to decline orders sent to their quotes. *See* ETA Letter.

326 A non-Liability Order is an order that when delivered imposes no obligation to respond under the Firm Quote Rule. *See* Proposed NASD Rule 4701(q).

327 *See* Heartland Letter.

328 *See* MSDW Letter.

329 *See* MSDW Letter.

330 *See* ITAC Letter and CSE Letter.

331 *See* Instinet Letter; and Bloomberg Letter.

332 *See* Instinet Letter; and Bloomberg Letter.

333 *See* Amendment No. 7, *supra* note 10.

334 *See* Amendment No. 7, *supra* note 10.

335 *See* Amendment No. 7, *supra* note 10.

336 *See* Bloomberg Letter.

337 *See* CSE Letter.

338 *See* Scudder Kemper Letter.

339 15 U.S.C. 78*o*-3(b)(6).

340 The Commission notes that market participants will still be able to preference market makers on a Liability Order basis. Under this option, market makers will not be exposed to double liability because preferenced orders are processed in the non-directed order queue.

341 *See* Securities Exchange Act Release No. 37619A (September 6, 1996), 61 FR 48290 (September 12, 1996) (order approving the Order Handling Rules).

342 *See* ACIM Letter.

343 *See* MSDW Letter.

344 *See* MSDW Letter.

345 *See* Island Letter.

346 *See* Island Letter.

347 *See* Island Letter.

348 *See* Instinet Letter.

349 *See* Instinet Letter.

350 *See* Amendment No. 7, *supra* note 10.

351 *See* Amendment No. 7, *supra* note 10.

352 *See* Amendment No. 7, *supra* note 10.

353 *See* Securities Exchange Act Release No. 40455 (September 22, 1998), 63 FR 51978 (September 29, 1998) (order approving File No. SR-NASD-98-01).

354 *See* CHX Letter.

355 *See* CHX Letter. The Commission notes that the NASD is currently working on amendments to the UTP Plan.

356 *See* STA Letter; STANY Letter; and Merrill Lynch Letter.

357 *See* STANY Letter.

358 *See* CHX Letter; *see also* Archipelago Letter.

359 *See* Merrill Lynch Letter.

360 *See* Merrill Lynch Letter.

361 *See* Amendment Nos. 4 and 6, *supra* notes 6 and 9.

362 *See* Amendment No. 6, *supra* note 9.

363 *See* CHX Letter.

364 *See* CHX Letter.

365 *See* CHX Letter. CHX noted that it is currently exploring with Nasdaq the possibility of allowing automatic execution UTP Exchanges to have the ability to revert to order-delivery if Nasdaq has systems delays.

366 *See* CSE Letter.

367 The Commission notes that Nasdaq is exploring other ways to accommodate UTP Exchanges. The Commission expects that some of the issues raised by UTP Exchanges will be further addressed in those discussions.

368 *See* discussion at Section V.I.3, Nasdaq as an Exclusive Securities Information Processor.

369 *See* STA Letter; STANY Letter; Salomon Smith Barney Letter; ITAC Letter; and MSDW Letter; *see also* Merrill Lynch Letter.

370 *See* STA Letter; STANY Letter; Salomon Smith Barney Letter; and MSDW Letter.

371 *See* Salomon Smith Barney Letter; STA Letter; STANY Letter; and MSDW Letter.

372 *See* Merrill Lynch Letter.

373 *See* Salomon Smith Barney Letter; MSDW Letter; Merrill Lynch Letter; STA Letter; and STANY Letter.

374 *See* Amendment No. 4, *supra* note 6.

375 *Id.*

376 *See* Island Letter.

377 Currently, odd-lots are automatically executed only against market makers who are at the inside bid/offer.

378 The Commission notes that any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal is excluded from the definition of an ECN. See 17 CFR 240.11Ac1-1(a)(8)(ii). An OTC market maker is defined as any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size. *See* 17 CFR 240.11Ac1-1(a)(13).

379 *See* ETA Letter; Merrill Lynch Letter; Goldman Sachs Letter; MSDW Letter; STA Letter; STANY Letter; ITAC Letter; ICI Letter; Bannon Letter; Bancorp Letter; Charles Schwab Letter; Congressman Drier Letter; Congressman Pallone Letter; Congresswoman Morella Letter; Congressman Stupak Letter; Congresswoman Wilson Letter; Congressman Towns Letter; Congressman McInnis Letter; Congressman Thomas Letter; Spear, Leeds & Kellogg Letter; First Union Letter; ITG Letter; Jeffries Letter; Congressman Ehrlich Letter;

Congressman Radanovich Letter; Congressman Shays Letter; Titak Letter; ASA Letter; APTC Letter; Philadelphia Corp. Letter; Garrett Letter; and Senator Schumer Letter.

380 *See* STA Letter.

381 *See* MSDW Letter.

382 *See* APTC Letter.

383 *See* Congressman Radanovich Letter.

384 *See* Bloomberg Letter.

385 *See* ETA Letter; Island Letter; Instinet Letter; Bancorp Letter; Archipelago Letter; Granite Financial Letter; ATD Letter; ACIM Letter; BRUT Letter; Phlx Letter; Leon Letter; Aurora Letter; Renaissance Letter; CSE Letter; and NexTrade Letter. In its comment letter, Island specifically questioned whether ECNs could compete in a regulatory environment structured to favor Nasdaq.

386 *See* ETA Letter; Island Letter; Bloomberg Letter; Instinet Letter; Leon Letter; and NexTrade Letter.

387 *See* Instinet Letter; *see also* Leon Letter.

388 *See* Instinet Letter.

389 *See* Instinet Letter; *see also* NexTrade Letter.

390 *See* Instinet Letter.

391 *See* Phlx Letter.

392 *See* Amendment No. 5, *supra* note 8.

393 *See* Amendment No. 7, *supra* note 10.

394 While market participants also may interact with quotes/orders below the top of the book in the SuperMontage, the Commission notes that directed orders will have to be for a size greater than the quoted size unless the Nasdaq Quoting Market Participant or UTP Exchange is willing to accept a directed Liability Order. As a result, the Commission believes that market participants will continue to have the same incentive to access ECNs for quotes/orders below the top of the book as they do today. In addition, customer orders routed to the SuperMontage will not "be insulated from best execution challenges" merely because the orders are routed to an SRO's market. Indeed, the Commission has noted in this release several instances where best execution may not be achieved within SuperMontage. *See e.g.*, discussions at V.D.2. and V.E.

395 *See* Section V.I.3, NASD as an Exclusive Securities Information Processor, *infra*.

396 *See* Securities Exchange Act Release No. 21433 (October 29, 1984), 49 FR 44042 (November 1, 1984).

397 *See* Division of Market Regulation, The October 1987 Market Break 9-3 to 9-15 (February 1988) ("1987 Market Break Report").

398 As described more fully in the 1987 Market Break Report, the number of market making positions declined more than 83 percent between October 19 and October 22, 1987. *Id.* at 9-14.

399 *See* Securities Exchange Act Release No. 25791 (June 9, 1988), 53 FR 22594 (June 16, 1988).

400 *Id.*

See NNMS Order, *supra* note 22.

401

402 *See* Bloomberg Letter.

403 *See* Bloomberg Letter.

404 *See* Amendment No. 5, *supra* note 8.

405 *See* Amendment No. 5, *supra* note 8.

406 *See* NNMS Order, *supra* note 22.

407 *See* Amendment Nos. 3 and 4, *supra* notes 5 and 6.

408 As Instinet stated, "[t]he NASD's proposal unnecessarily ties together two distinct services provided by Nasdaq -establishing a mandatory linkage between (i) Nasdaq's facilities for *displaying and making quotes accessible* under the Commission's order display rules (*i.e.*, the Order Handling Rules and Regulation ATS) and (ii) Nasdaq's new ECN-like facility for *automatically matching individual quotes and orders*." *See* Instinet Letter (emphasis in original).

409 *See* Securities Exchange Act Release No. 42455 (February 24, 2000), 65 FR 11401 (March 2, 2000).

410 *See* Securities Exchange Act Release No. 43767 (December 22, 2000), 66 FR 834 (January 4, 2001).

411 *See* Securities Exchange Act Release No. 43608 (November 21, 2000), 65 FR 78822 (December 15, 2000) (noticing proposed rule change (SR-PCX-00-25) that the Archipelago ECN become a facility of PCX).

412 15 U.S.C. 78k-1.

413 15 U.S.C. 78k-1.

414 *See* ETA Letter; NexTrade Letter; Instinet Letter; Bancorp Letter; STA Letter; Bloomberg Letter; Island Letter; BRUT Letter; Phlx Letter; Renaissance Letter; ACIM Letter; Erfort Letter; and Archipelago Letter (stating that the SuperMontage will "pose insurmountable conflicts"); *see also* Scudder Kemper Letter.

415 *See* Bloomberg Letter; *see also* Renaissance Letter and Archipelago Letter.

416 *See* BRUT Letter.

417 *See* Island Letter; Instinet Letter; and NexTrade Letter; *see also* Scudder Kemper Letter.

418 *See* NY Letter and Instinet Letter.

419 *See* ETA Letter; Archipelago Letter; and Instinet Letter.

420 *See* BRUT Letter.

421 *See* STA Letter.

422 *See* Archipelago Letter.

423 *See* ETA Letter; Instinet Letter; Island Letter; and Bancorp Letter. In contrast, Archipelago believed that the conflicts will diminish if Nasdaq were *entirely* independent of the NASD.

424 *See* Archipelago Letter; *see also* Renaissance Letter.

425 *See* Archipelago Letter.

426 *See* Archipelago Letter. *See* Commission discussion at Section V.I.3.

See STANY Letter; ACIM Letter; and ITG Letter. ITG requested clarification

427 regarding the fees for the NODF and OCF.

428 *See* Renaissance Letter.

429 *See* Renaissance Letter.

430 *See* Renaissance Letter.

431 *See* Renaissance Letter. As discussed above, the Commission notes that the SuperMontage will not be the sole means for providing or accessing liquidity. Broker-dealers may continue to pursue other alternative order routing and execution services that provide value to their customers. As a result, the Commission believes that competitive pressures may limit the fees associated with the SuperMontage. *See* discussion at V.I.1.

432 Section 3(a)(26) of the Act defines an SRO as "[a]ny national securities exchange, registered securities association, or registered clearing agency ." *See* 15 U.S.C. 78c(a)(26). Section 3(a)(1) of the Act defines an exchange as "[a]ny organization, association, or group of persons ... which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities ...." *See* 15 U.S.C. 78c(a)(1).

433 *See* 15 U.S.C. 78*o*-3(b)(4), (7), and (8).

434 15 U.S.C. 78*o*-3(a)(5). *See also* 15 U.S.C. 78*o*-3(b)(9) and (11), and 15 U.S.C. 78k-1(a)(1)(C). The Commission notes that the NASD will file a separate proposal to establish fees for the SuperMontage. The NASD has committed to the creation of a SuperMontage fee structure that does not discriminate between Nasdaq market participants that interact with the system on an order-delivery versus an automatic execution basis. The NASD has also committed to avoiding systemic biases including biases that result from differential fees or incentives between quotes and orders, whether they are directed, non-directed, or preferenced. *See* Amendment No. 8, *supra* note 12.

435 This would not preclude the NASD from contracting with Nasdaq for services.

436 Moreover, the NASD should not share its regulatory data with Nasdaq for business purposes. When Nasdaq registers as a national securities exchange, it will have its own regulatory responsibilities as an SRO separate and apart from the NASD. Market participants will choose whether to be members of Nasdaq or the NASD. In reviewing for-profit exchanges, including Nasdaq's proposal, the Commission is considering ways to minimize the potential heightened conflict of interests. *See also*, discussion at Section V.I.3, NASD as an Exclusive Securities Information Processor.

437 For example, the fact that SOES was available in the past did not mean that broker-dealers were forced to use it to execute customer orders, nor did it free a broker-dealer from its duty to consider price improvement opportunities.

438 *See* Amendment No. 8, *supra* note 12.

439 *See* Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844 (December 22, 1998). To date, two ECNs have applied to register as exchanges. As noted in note 411, *supra*, PCX has proposed that Archipelago become a facility of the Exchange.

440 *See* Bloomberg Letter; Scudder Kemper Letter; Instinet Letter; and Archipelago Letter.

441 *See* Bloomberg Letter; Scudder Kemper Letter; Instinet Letter; and Archipelago Letter.

442 *See* Archipelago Letter and CSE Letter.

443 Under Section 3(a)(22)(B) of the Act, the term "exclusive processor" is defined as a "securities information processor which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange

or registered securities association ... in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association." 15 U.S.C. 78c (22).

444 Archipelago Letter and Instinet Letter. *Also see* Gramm Letter; Scudder Kemper Letter; ACIM Letter; and BRUT Letter.

445 *See* Amendment No. 8, *supra* note 12.

446 *See* Instinet Letter; Brut Letter; NY Letter; Investment Companies Letter; ACIM Letter; Archipelago Letter; Scudder Kemper Letter; and CHX Letter.

447 *See* Instinet Letter; Brut Letter; Archipelago Letter; and NY Letter.

448 *See* Instinet Letter; Brut Letter; and NY Letter.

449 *See* Instinet Letter and Brut Letter.

450 *See* Instinet Letter and Brut Letter (citing S. Rep. No. 94-75, at 11-12 (1975); *see also* ACIM Letter; Scudder Kemper Letter; Archipelago Letter; and CSE Letter.

451 *See* Brut Letter.

452 *See* CHX Letter.

453 *See* Brut Letter.

454 *See* Instinet Letter and Brut Letter.

455 *See* Instinet Letter. The Commission notes that the NASD has committed to provide an alternative quotation and transaction reporting facility for its members who transact business in the residual over-the-counter ("OTC") market. The term residual OTC market "refers to transactions by NASD members otherwise than on an exchange or Nasdaq, *in securities listed on an exchange or Nasdaq*, but not reported elsewhere. *See* letter from Robert Glauber, Chief Executive Officer and President, NASD, to Arthur Levitt, Chairman, Commission, dated December 13, 2000.

456 *See also* Archipelago Letter.

457 Pub. L. 94-29, 89 Stat. 97 (1975).

458 See 15 U.S.C. 78k-1(b).

459 AMEX has withdrawn from the UTP Plan. The Boston Stock Exchange ("BSE") is a limited participant. A "limited participant" is a national securities exchange whose participation in the Nasdaq/UTP Plan is restricted to reporting market information. Recently, CSE became a full participant in the UTP Plan.

460 The UTP Plan terminates in March, 2001. *See* discussion below regarding the need to re-evaluate the plan in light of market changes.

461 Exchange Act Rule 11Aa3-2 establishes the procedures that govern amendments to each of the Plans. In addition, Section 19(b) of the Act, and Rule 19b-4 thereunder, govern proposed rule changes by the NASD that relate to the Nasdaq System. In general, all amendments to the Plans and NASD rules must be filed with the Commission, published for public comment, and approved by the Commission.

462 *See* 17 CFR 11Aa3-2.

463 *See* letter from Robert Glauber, Chief Executive Officer and President, NASD, to Arthur Levitt, Chairman, Commission, dated December 13, 2000.

464 *See* letter from Frank Zarb, Chairman and CEO, Nasdaq, to Senator Phil Gramm, dated October 24, 2000. The UTP Plan outlines the responsibilities of UTP Plan participants but does not provide a comprehensive or exclusive set of terms that govern the interaction of the markets. Because the UTP Plan only covers distribution and other basic terms, it is not uncommon for the NASD and UTP Plan Participants to negotiate terms for dealing with each other separate from the UTP Plan. For instance, the NASD negotiated the terms of participation in the OCF function of SuperMontage with the UTP Plan's only active participant, the CHX. *See* Amendment No. 4, *supra* note 6. In addition, Nasdaq discussed with Archipelago its participation in the OCF function as a UTP Exchange in light of the proposal for Archipelago to become a facility of the PCX.

465 The Commission notes that its discussion of possible changes to the UTP Plan should not be interpreted as necessary pre-conditions to the implementation of the SuperMontage.

466 *See* Form 1 submitted on November 9, 2000.

467 The Commission will consider allowing an additional 3 months for negotiation if it is requested by the participants for good cause.

468 *See* Amendment No. 9, *supra* note 14.

469 See Amendment No. 8, *supra* note 12.

470 15 U.S.C. 78*o*-3(b)(9).

471 *See* Senate Report at p. 8, *supra* note 37.

472 Amendment No. 6 to the proposal makes clear that UTP Exchanges have a similar option. *See* note 9, *supra*.

473 The Commission also notes that like today, all ECNs (even if they are order delivery participants in the system) will be able to automatically execute against market maker quotes. In addition, order delivery ECNs will continue to receive messages that include the identity of the market participant hitting their quote. *See* Amendment No. 8, *supra* note 12.

474 15 U.S.C. 78o-3(b)(9).

475 *See* ITAC Letter; ETA Letter; Bancorp Letter; Bloomberg Letter; STA Letter; STANY Letter; NexTrade Letter; Salomon Smith Barney Letter; Instinet Letter; and MSDW Letter; *see also* CHX Letter; Renaissance Letter; and ACIM Letter.

476 *See* ETA Letter; Bancorp Letter; STANY Letter; STA Letter; Salomon Smith Barney Letter; Instinet Letter; and NexTrade Letter.

477 *See* Bloomberg Letter.

478 *See* Archipelago Letter.

479 *See* Archipelago Letter.

480 Nasdaq also noted that while market participants may give Nasdaq multiple levels of orders for display in the system, they are not required to do so. Market participants may opt to give Nasdaq only their top of file - as they do today - as long as they comply with the Commission's Order Handling Rules.

481 *See* Amendment No. 5, *supra* note 8.

482 The NASD represented that there are 30 programmers who are dedicated to Nasdaq's efforts to achieve decimals. Nasdaq explained that these resources will not be used or otherwise diverted from its efforts to achieve trading in a decimal environment, nor will other resources related to achieving decimalization - such as quality assurance and testing personnel - be used at the expense of completing decimalization efforts.

483 The NASD also explained that the SuperMontage uses dedicated Tandem computing resources for development and integration testing while sharing the actual production testing facilities with other Tandem-based applications. The decimalization of other Tandem legacy applications, such as SOES, SelectNet, and ACT, use different resources.

484 All NASD and NASD Regulation activities have been out-sourced to Electronic Data Systems, which relieves the Nasdaq team of any billing or administrative technology burdens. Systems development for the American Stock Exchange is managed by a fully independent team that is now out-sourced to SIAC.

485 On a temporary basis, it will be possible to operate the NODF side-by-side with the NNMS and SmallCap SOES systems, and for a security to trade on either the NODF or the NNMS/SmallCap SOES, but not both simultaneously. In Amendment No. 5, the NASD described the roll out of the system in greater detail. *See* Section III.K, *supra*.

486 *See* Securities Exchange Act Release Nos. 27445 (November 16, 1989), 54 FR 48703 (November 24, 1989) and 29185 (May 9, 1991), 56 FR 22490 (May 15, 1991) ("ARP II").

487 *See* Amendment No. 6, *supra* note 9.

488 15 U.S.C. 78c(f).

489 15 U.S.C. 78c(f).

490 15 U.S.C. 78*o*-3(b)(6).

491 15 U.S.C. 78*o*-3(b)(6) and 78s(b).

492 15 U.S.C. 78s(b)(2).

http://www.sec.gov/rules/sro/nd9953o.htm